

THE EVALUATION OF DIFFERENT RETIREMENT INVESTMENT OPTIONS AS SAVINGS AND TAX PLANNING TOOLS

by

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Submitted in partial fulfilment of the requirements for the degree
MCom in Taxation

in the

FACULTY OF ECONOMIC AND MANAGEMENT SCIENCES

at the

UNIVERSITY OF PRETORIA

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Date of submission:

2011-11-08

ABSTRACT

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Throughout South Africa, people are faced with various decisions with regard to planning for their future, but more so in planning for their retirement.

It happens quite often that these investment decisions are postponed until only a few years before retirement, whether it is because of personal circumstances (cash flow restrictions) or changing employment. A number of people simply forget to plan for their retirement.

Investment for retirement has become increasingly complex because of the great number of investment choices available and therefore this research attempts to identify and evaluate the most commonly used retirement investment opportunities in the market with their respective advantages and disadvantages.

The research focuses on investment opportunities from a savings point of view and also evaluates each option from a South African income tax point of view which includes the cash inflows and outflows at the different stages (during the investment period as well as the maturity/retirement period). A number of investing options might seem very attractive at the initial phase, but may be less attractive at retirement or maturity date (especially looking at the tax benefits). This study focuses on both the current and newly proposed legislation as presented during the recent budget speech by the current Minister of Finance, Pravin Gordhan.



Key words:

Retirement investment options

Retirement planning

Tax planning

Pension funds

Provident funds

Retirement annuity funds

OPSOMMING

DIE EVALUASIE VAN VERSKILLENDE AFTREE BELEGGINGS OPSIES AS N BESPARIINGS EN BELASTING BEPLANNINGS MEGANISME

deur

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Regoor Suid-Afrika word mense gekonfronteer met besluite ingevolge die beplanning vir hul toekoms asook die beplanning vir hul aftrede.

Dit gebeur gereeld dat hierdie beleggingsbesluite uitgestel word as gevolg van persoonlike omstandighede (wat kontantvloeibeperkings insluit) asook as gevolg van verandering van werkgewers. Party mense laat eenvoudig na om vir aftrede te beplan.

Om te belê vir aftrede word toenemend moeiliker as gevolg van die hoeveelheid beleggingsopsies beskikbaar. Hierdie navorsing poog dus om die mees algemene beleggingsopsies wat beskikbaar is, te identifiseer tesame met elkeen se individuele voordele en nadele.

Die navorsing fokus op beleggingsgeleenthede vanuit 'n besparingsoogpunt asook die Suid-Afrikaanse inkomstebelasting gevolge van elk van die opsies. Die Suid-Afrikaanse inkomstebelasting gevolge sluit in die kontantinvloei en -uitvloei tydens die duur van die beleggings asook by aftrede. Baie beleggingsopsies lyk aantreklik op die beleggingsdatum maar kan nadelig wees by aftrede. Die belastingontleding fokus op beide die huidige wetgewing asook die voorgestelde verandering in die wetgewing soos voorgestel tydens die begrotingsrede deur die huidige Minister van Finansies, Pravin Gordhan.



Sleutelwoorde:

Aftreebeleggingsopsies

Aftreebeplanning

Belastingbeplanning

Pensioenfonds

Voorsorgfonds

Uittree-annuiteit

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THE EVALUATION OF DIFFERENT RETIREMENT INVESTMENT OPTIONS AS A SAVINGS AND TAX PLANNING TOOL

CHAPTER 1

INTRODUCTION AND RESEARCH PROPOSAL

1.1 BACKGROUND

“No matter where one is in life, there’s always tomorrow. How rewarding one’s future is depends on how well one plans and make provision for it now.” (Investec Asset Management, 2011b:2.)

Most people hope to retire in comfort, but statistics show that only 4% of South Africans manage to do so. Unfortunately 12% simply manage, 33% have to scale down their lifestyles significantly and the worst of all, 51% retire in circumstances that oblige them to supplement their income or rely on others for additional support. (Hirsch, 2005:22.)

Throughout South Africa, people are faced with various decisions with regard to the planning for their future, but more so in planning for their retirement. This is specifically a difficult situation for the younger generation that is entering the workforce. The last thing on their minds when starting to work and to earn an income for the first time is retirement, considering that it is about 40 years away (Cameron, 2008:23).

These difficulties with regard to retirement investment decision making may, however, not only be limited to the younger generation. It happens quite often that more senior people delay these investment decisions, whether it is because of personal circumstances (cash flow restrictions) or changing employment and the resultant reinvestment decisions.

A number of people forget to plan for their retirement. Planning and investing can be compared to insurance. Many people think of these issues as a pain purchase. Unfortunately one has very little choice. One will get old and will have to retire eventually. (Retirement Planning Advice, Not dated.)

Quite often, if not always, future investors are faced with a number of questions with regard to saving for retirement. These questions include: When do I want to retire? How much will I need to enable me to retire? Lastly and probably the most important question: What are the investment options available and in which option do I need to invest. (Investec Asset Management, 2011a:1.)

There are various retirement investment options in the market currently – each with different advantages and disadvantages. Investment for retirement has become increasingly complex because of the great number of investment choices available. The misuse of investment choices due to lack of knowledge or poor advice has resulted in many retirement savings being significantly diluted (Cameron, 2008:93). The most common investment options used in the market are pension funds, retirement annuity funds, provident funds and - to a lesser extent - unit trusts. Each of these has their own set of rules, advantages and disadvantages that need to be considered in context.

Looking at this from a South African Government's point of view, the state makes pensions available to only the poorest people in South Africa. Fiscal encouragement has therefore been given to citizens to make their own provision for retirement through collective or individual arrangements. This has been one of the points highlighted in the last few years' annual budget proposal presented by the Finance Minister and which was re-emphasised by the current Finance Minister, Pravin Gordhan (Department of National Treasury, 2011:29), who announced/ proposed a change in the current tax legislation in this regard.

As emphasised earlier, no person can and is able to work forever. Considering that the vast majority of South Africans retire poor, making the right investment decision as early as possible is crucial. It provides enough time to contribute sufficiently

towards the desired scheme (increase in capital contributions but also increase in capital where interest is earned on interest – compound interest) as well as to maximise potential future tax deductions. (Hirsch, 2005:24.) It is therefore vital to consider the facts objectively in the light of each person's circumstances as well as reconsidering savings strategies due to changes in legislation.

1.2 PROBLEM STATEMENT

There are various financial advisors in the market who are marketing their own specific products, including retirement investment options. Limited research was found to highlight the similarities in most of the products and to compare the different options available. The lack of this information could limit future investors to a small number of options presented, and them not arriving at the most optimal investment portfolio from both a risk (all one's eggs in one basket) and a tax benefit point of view. The problem is therefore to identify and evaluate the most commonly used retirement investment opportunities in the market with their respective advantages and disadvantages.

1.3 PURPOSE STATEMENT

In comparing the different retirement investment options available, this research enables future investors, but more specifically the younger generation entering employment, to make more informed decisions with regard to the advantages and disadvantages of the different investment opportunities.

Investing for retirement is arguably one of the most important things that one can do should one wish to enjoy retirement. This sounds much easier than it is in real life, especially when one normally has to accept that retirement planning goes hand-in-hand with limited resources available. Limited resources include limited time until retirement, availability of additional money to make the necessary investments as well as limited retirement investment knowledge.

This research attempts to identify and evaluate the most commonly used retirement investment opportunities in the market with their respective advantages and disadvantages.

The research further highlights the investment opportunities from a savings point of view (making provision for retirement), but also evaluates each option from a South African income tax point of view. The research includes the cash inflows and outflows at the different stages (during the investment period as well as the maturity/retirement period) as a number of investing options might seem very attractive at the initial phase, but maybe limiting at retirement or maturity date. It focuses on both the current and newly proposed legislation as presented during the recent budget speech by the current Minister of Finance, Pravin Gordhan.

1.4 RESEARCH OBJECTIVES

The study is focused on the following research objectives:

- to critically evaluate the various retirement investment options as savings tools; and
- to provide guidelines for understanding the Income Tax Act 58 of 1962 as a preamble to analysing the various retirement investment options as tax planning tools based on current and newly-proposed legislation.

1.5 DELIMITATIONS OF THE STUDY

The proposed study has several delimitations related to the context, constructs and theoretical perspectives. Firstly it will be limited to the most commonly used retirement investment vehicles namely pension funds, provident funds and retirement annuity funds. There might, however, be mention of other retirement investment vehicles for information purposes. A detailed review of selected items is to be done.

Secondly, the study's focus is on evaluating each of the selected retirement investment vehicles from a South African income tax point of view, more specifically

the Income Tax Act 58 of 1962. The focus is mainly on the normal income tax effects of these retirement investment vehicles from the employee/investor's point of view. Literatures from related disciplines such as other taxes (Value-Added Tax Act 89 of 1991 and, Estate Duty Act 45 of 1955) as well as human resources (Pension Fund Act 24 of 1956) are consulted in passing.

Finally, the study's literature review is primarily focused on the currently enacted Income Tax Act. Any significant changes relating to this act until the date of submission are briefly mentioned as part of the study's outcome without a significant in-depth review.

1.6 ASSUMPTIONS

This study makes certain assumptions concerning the knowledge of individuals with regard to retirement investment decision-making. The assumptions used in this research include:

- the reader of this research document has limited knowledge of the various retirement investment options available, hence the focus only on the most commonly used;
- the reader of this research document has limited knowledge of taxation, specifically income tax with regard to natural persons and also the various taxation implications of the retirement investment options under review; and
- that there is a certain amount of theoretical literature available to highlight and explain the various tax implications of retirement investment vehicles according to the requirements of the various sections of the Income Tax Act. The research is therefore limited in this regard to only a few of the pieces of literature referred to as part of this study.

1.7 DEFINITION OF KEY TERMS

This document contains a number of key terms that, for the purpose of this document, are defined as follows:

- **Marginal rate of tax:** Any earnings that are taxed at the highest rate of tax – earnings above R580 000 taxed at 40% (Hirsch, 2005:34).
- **Pension funds (defined benefit and defined contribution):** Funds that are arranged by employers, whereby the employees subscribe a percentage of their salaries and the employer pays a similar or larger amount per employee. The amounts are invested in assets including equity (shares), properties and prescribed assets (gilts) for the benefit of the employee. On retirement the employee receives a lump sum and a proportion (related to the number of years worked) of his or her final salary as an income. The contract is normally between the employees and the employer. (Hirsch, 2005:112.)
- **Preservation funds:** A preservation fund is a pension or provident fund, registered with the Registrar of Pension funds and approved by the SARS. It is a fund in which employees, who leave the service of a participating employer due to dismissal (including retrenchment) or resignation, or in the event of the termination of the employer's pension or provident fund, may invest their accrued fund benefits. (South African Financial Advice, 2011.)
- **Provident funds:** Funds where the employee and employer both make contributions to a fund based on percentage of the employee's salary. On retirement the employee receives a lump sum payment from the fund. (Cameron, 2008:40.)
- **Retirement:** Retirement takes place over a number of years, but according to tax legislation one retires at any stage after the age of 55. Retirement does not mean that one needs to stop working. (Cameron, 2008:165.)
- **Retirement annuity funds:** These are funds where an individual pays premiums every month and receive a lump sum and annuities when he or she retires or at a given future date. Monthly contributions are invested in a combination of prescribed assets and equity. The contract is between the individual and the insurance company. (Hirsch, 2005:114.)

Various abbreviations are used throughout this document (refer to Table 1).

Table 1: List of abbreviations

Abbreviation	Meaning
Income Tax Act	Income Tax Act 58 of 1962
CGT	Capital gains tax
RAF	Retirement annuity funds
SARS	South African Revenue Services

1.8 RESEARCH DESIGN AND METHODS

The research design is a qualitative, non-empirical design. This research is a literature review and focuses on retirement investment decision-making and includes the evaluation of the most commonly used investment vehicles used as well as the advantages and disadvantages thereof. Included in the advantages and disadvantages is a detailed review of the taxation implications of each option available.

1.9 SUMMARY OF ENSUING CHAPTERS

The current study focuses mainly on the most commonly used retirement investment vehicles as both investment and tax-planning tools. Chapter Two mainly discusses the important considerations for making retirement investment decisions as well as a few retirement investment options with their respective advantages and disadvantages.

The key considerations in deciding which retirement investment vehicle to use are the tax implications of the decision. Chapter Three provides a brief overview of the tax legislation and then focuses more specifically on the current enacted tax legislation with regard to pension funds, provident funds and retirement annuity funds as well as the newly proposed legislation introduced during the 2011 Budget Speech presented by the Minister of Finance, Pravin Gordhan. Detailed focus is given on the tax implications of these retirement investment vehicles during the initial investment phase as well as the lump sum payments on retirement.

Chapter Four provides a comparison between and a summary of the most commonly used retirement investment options available (pension funds, provident funds and retirement annuity funds) as both a savings tool and a tax planning tool (using the currently enacted and newly proposed tax legislation).

Finally, Chapter Five concludes by summarising the key aspects of each option dealt with in the preceding chapters and recommend a few areas for future studies to expand on the concept of tax planning.

CHAPTER 2

RETIREMENT INVESTMENT PLANNING AND STRATEGY

2.1 INTRODUCTION

It is virtually impossible to finalise one's retirement investment plan the day one receives one's first salary. There are too many life-changing events that occur from the day one receives one's first salary until retirement. One therefore has to adapt one's plans accordingly. (Hirsch, 2005:5.)

To put an investment strategy together is like building a jigsaw puzzle. To do this properly, it is a prerequisite to understand the broader picture first. As with a jigsaw puzzle, one must set down the corners and edges with the objective of containing all the other pieces - the bigger picture when everything has been fitted as designed. (Hirsch, 2005:5.)

For a retirement investment strategy to succeed, it should form part of one's overall financial plan and not to be implemented in isolation. All one's goals in life should be taken into account and one should decide on the important things that will cost money such as educating children, buying a home and - very important – how one wants to retire! In order to get one's retirement right, one needs to balance one's goals. (Cameron, 2008:1.)

If one aims to get one's retirement right, understanding the problem areas is of significance. One does not have to be an expert in retirement planning, but one should have a sound understanding of what retirement entails, including the basics of investment and tax structures (Cameron, 2008:7).

2.2 IMPORTANT CONSIDERATIONS FOR RETIREMENT INVESTMENT

For most people, retirement savings amount to their biggest investment. The amount saved might still not be enough even though they started early and did not draw on those savings along the way.

Both Cameron (2008:7-21) and Hirsch (2005:22-50) highlight the following reasons why people do not retire financially secure:

- ***Lack of proper planning***

People do not realise they need to have a financial plan for retirement and continuously revise the plan, leaving planning until a few years before retirement. If one fails to plan, one plans to fail. Planning includes setting goals, budgeting accordingly and obtaining appropriate advice.

- ***Longevity***

Currently the life expectancy of South African men is approximately 82 and that of a South African woman, is 86. This is much longer than a few years ago highlighting the importance of proper planning and saving. Now one might need to plan for 25 years of retirement life instead of maybe 20 years as in the past.

- ***Retirement gap***

Salaries received from employers are divided into two categories, namely one's pensionable income (straight salary) and non-pensionable benefits. Pensionable income is used to calculate the retirement fund contributions whereas the non-pensionable income consists of benefits such as housing allowance, motor vehicle allowances and one's annual bonus. In most employer-sponsored pension savings schemes one sees a reduction in income of at least 20% after retirement as these funds are aimed at realising a pension of 70% to 80% of one's final salary. This shortfall is called the retirement gap.

- ***Non-preservation***

The average South African changes jobs at least seven times in his or her career. A number of these people who change jobs often do not retain their retirement savings, but instead spend the money on various luxuries including new cars. These actions lead to significant shortfalls at retirement.

- ***Starting too late***

A late start in retirement savings results in a reduced capital amount available for growth and ultimately delays the retirement date. This is often the case with self-employed people who would like to establish their careers first and then start thinking of retirement.

- ***Early retirement/retrenchment***

Early retirement has several consequences which include a loss of contributions to a fund (own and employer contributions), loss of investment returns for the years of early retirement (normally the biggest growth), additional years added to retirement years (money could run out sooner) and lastly the younger one is the more a guaranteed pension will cost (longer expected life). An extra five years from age 60 can increase one's pension by up to 80 percent.

- ***Inflation***

Inflation is an important consideration for both the build-up as well as at retirement. One should save at a rate that is greater than inflation. Inflation determines how much one has to save, but also what investment strategy to follow. An inflation rate of 7,2% actually means that the buying power of the rand will be halved every ten years - thus again highlighting the importance of beating inflation on the returns of one's investment (this principle is also confirmed by Jones (2011a:1)).

- ***Poor investment decisions:***

Poor investments are made because of the complexity of investment products on offer with a wide range of choices, poor and unqualified advice as well as investor greed and fear. High-risk investments may reduce one's investment savings as surely as being too conservative. There should be a balance between the risk one would want to take and being too conservative.

Jones (2011a:1) confirms that people with modest earnings may also accumulate a substantial amount through retirement saving by contributing to a retirement fund their entire working life and preserving their retirement benefits whenever they change jobs. The important factors to this success story are time and compounded growth.

Retirement planning changes according to the different stages of one's life. In the early stages, the focus is on hitting the bigger target, but the closer one gets to retirement one should aim to hit the bull's eye. One therefore should start as early as possible with retirement investment without having to be too specific (investing towards general goals), and the closer one gets to retirement, the retirement plans needs to be refined and then one should invest accordingly.

Cameron (2008:27-29) divides retirement planning into the following age groups with the respective guidance at each stage:

- ***20 to 30 age group***

One needs to aim at general targets as it is almost impossible to predict how much one needs when retiring in 40 - 45 years. It is best to start off with a percentage of one's income. Financial advisors recommend that the minimum should be at least 10 times one's required annual retirement income. Assuming one would require R120 000, one needs an absolute minimum saving of R1,2 million. This assumes that one receives a 10% return per year. It would, however, be much safer saving about 20 times one's required retirement income to eliminate the impact of inflation and taxation. Compound interest is a huge advantage for this age group. What this means in simple terms is that one earns interest on interest. Remember, the sooner one starts saving the greater one's retirement investment. It is the first rands that one invests that earn the most.

- ***30 to 50 age group***

This is the time one should start to refine one's retirement savings plans, where one should have an idea where one is going with one's career. Unfortunately, this time also brings about the biggest expenditure – educating and maintaining a family. One should now start targeting the amount of capital one requires instead of just working on a percentage of income saved.

- ***50 to retirement***

This is the time where expenditure should reduce (children would be educated or almost finished), resulting in additional amounts to be saved for retirement. One should now be in a position to fine-tune the retirement targets. If one does

not have sufficient money to retire, other options have to be considered. These options include: extending the retirement date, taking on a post-retirement job or cutting back dramatically on one's lifestyle.

Hirsch (2005:22-23) has a similar view that divides life into four stages namely:

- **First 17 years** – focusing on one's education;
- **17 – 34 years** – further education and finding out exactly what one wants to do with one's life;
- **34 – 51 years** – concentrating on one's career and making changes that improve one's situation; and
- **51 – 68 years** – planning for retirement.

During the first 3 stages one can afford to take some risks, but during the final stage before retirement one cannot afford to take any risks with regard to the capital invested in order to maximise the investment through compounded growth.

No matter whether there are 3 or 4 stages in one's life, financial planning has to start at least 40 - 45 years before retirement to ensure enough income for one's retirement years. The lack of sufficient time should not put people off from saving, but would require urgent attention. (Hirsch, 2005:5.) It is therefore of utmost importance to plan for one's retirement. If one does not know one's destination, one will not reach it.

2.3 RETIREMENT INVESTMENT CHOICES

When saving for retirement there are a number of choices available. One of the first decisions that one should make is whether to use a specific tax incentivised retirement investment vehicle or one with no incentives, or a combination (Cameron, 2008:31).

One needs to be aware that there are limits to tax incentives offered on retirement savings vehicles. It is unwise to argue that one can get better investment returns outside of tax incentivised retirement vehicles. By not having to pay tax/reducing

one's taxable income when one invests in a retirement fund one is using money that would have been paid to SARS to earn extra money. One could also say that savings are done with pre-tax money.

There are a number of retirement investment vehicles available in the market. The main features of each of the following retirement investment vehicles are discussed and should be considered when making an investment choice:

- defined benefit pension funds;
- defined contribution pension funds;
- defined contribution provident funds;
- retirement annuities; and
- preservation funds.

A discussion on each of these retirement investment vehicles follows.

2.3.1 Defined benefit pension funds

This is a scheme where both the employer and employee contribute. Cameron (2008:35-37) highlights the following main features of this fund:

- the employer takes the investment risk and undertakes that the employee will receive a pension of a predetermined level at retirement;
- the pension is calculated on a formula based on the employee's final salary at retirement, the number of years that the employee was a member of the fund and a percentage of his or her salary;
- on retirement the employee is entitled to take up to a maximum of one third of the total pension as a lump sum cash payment except where two-thirds of the total value does not exceed R50 000. The formula for calculating the third takes into account the employee's age at retirement and the average expected date of all members;

- the lump sum is taxed at a more favourable average rate of tax per section 6(1) of the Income Tax Act;
- at least two-thirds of the total pension must be used to provide a monthly pension for life (a compulsory purchase annuity);
- normally, defined benefit pension funds also provide group life assurance against death and/or disability that falls away on retirement;
- the employee's dependants receive the benefits of the fund when the employee dies (in addition to the group life assurance). The dependants' pension is based on what the employee could be expected to earn at normal retirement age, but they normally receive a reduced pension (the reduction may be up to 50%);
- the pension fund might not keep up with inflation therefore the board of trustees may decide whether to increase the pension fund based on the excess investment income;
- the advantages of good investment performance are to the benefit of the fund and the trustees may decide whether or not to pass on those benefits by way of pension increases;
- often, when an employee changes jobs, he or she may not be able to take more than their own contributions and the growth thereon. Fund rules have changed substantially, however, and they do sometimes permit the employee to take the full amount accrued to them;
- employee's inputs into investment decisions or options of the contributions are very limited. The employer provides a guarantee of a specific pension therefore the risk lies with the employer to make proper investments;
- various tax benefits exist (to be discussed in the following chapter); and
- the fund must be registered with the Registrar of Pension Funds (section 4(1) of the Pension Fund Act).

2.3.2 Defined contribution pension funds

This is a scheme where both the employer and employee contribute and is known as a money purchase scheme. Cameron (2008:37-40) highlights the following main features of this fund:

- the employer does not guarantee a specific pension, but does guarantee to make a specific contribution;
- contributions are calculated as a percentage of the employee's pensionable salary (both the employee's and the employer contribution which can vary). Record is kept of all contributions (employee and the employer) as well as capital and income growth of the investment. The employee carries the loss should the investment perform poorly and should the investment perform well, the employee receives the benefit;
- on retirement, the employee is entitled to take up to a maximum of one third of the total pension as a lump sum cash payment except where two-thirds of the total value does not exceed R50 000. The third is calculated based on the actual amount accumulated in the employee's fund;
- at least two-thirds of the total pension must be used to provide a monthly pension for life (a compulsory purchase annuity). The employee's pension may either be provided by the fund or the employee may purchase a pension from a life insurance company;
- generally pensions do not keep up with inflation. When guarantees are provided, the initial pension is much lower in order to still provide a pension for the specific period;
- there is no cross-subsidisation between the members as in a defined benefit fund. An employee's retirement savings are retained as his or her share of the fund;
- the employee therefore takes the investment risk and should the markets collapse, the employee has to make up the shortfall on retirement. The contrary is also true. Should the markets perform well, the employee receives the benefits;

- the employee has a say in the investment of the contributions based on choices provided by the employer;
- if the employee changes jobs, he or she can usually take the full amount accrued (employee's and the employer's contributions as well as the growth). In some instances the employer's contributions are only available after a number of years' service or based on a sliding scale according to the number of years of service;
- defined contribution pension funds normally also provide group life assurance against death and/or disability which usually falls away on retirement. The employees are covered whether at work or at home;
- the employee's dependants receive the benefits of the fund when he or she dies (in addition to one's group life assurance). The employee's dependants receive only the accumulated holdings in the fund (all contributions plus investment growth);
- various tax benefits exist (to be discussed in the following chapter); and
- the fund must be registered with the Registrar of Pension Funds (section 4(1) of the Pension Fund Act).

2.3.3 Defined contribution provident funds

The defined contribution pension fund and defined contribution provident fund are basically similar but with some differences. Cameron (2008:40-43) highlights the following main features of this fund:

- the employer does not guarantee a specific pension, but does guarantee to make a specific contribution;
- contributions are calculated as a percentage of the employee's pensionable salary (both the employee's and the employer's contribution which can vary). A record is kept of all contributions (employee's and the employer's) as well as capital and income growth of the investment. The employee carries the loss should the investment perform poorly, and should the investment perform well the employee receives the benefit;

- the employee may take the entire amount as a lump sum at retirement without any obligation to purchase a pension for life. This is currently a significant risk to ensure sufficient income for the employee's retirement;
- there is no cross-subsidisation between the members as in a defined benefit fund. The employee's retirement savings are retained as his or her share of the fund;
- the employee takes the investment risk therefore, should the markets collapse, the employee has to make up the shortfall on retirement. The contrary is also true. Should the markets perform well, the employee receives the benefits;
- the employee has a say in the investment of the funds based on choices provided by the employer;
- if one changes jobs, the employee can usually take the full amount accrued to him or her depending on the number of years of service;
- a defined contribution provident fund also normally provides group life assurance against death and/or disability that usually falls away on retirement. The employees are covered whether at work or at home;
- the employee's dependants receive the benefits of the fund when he or she dies (in addition to one's group life assurance). The employee's dependants receive only the accumulated holdings in the fund (all contributions plus investment growth);
- various tax benefits exist (to be discussed in the following chapter); and
- the fund must be registered with the Registrar of Pension Funds (section 4(1) of the Pension Fund Act).

2.3.4 Retirement annuity funds (RAF)

Retirement annuities are basically individual saving plans with tax advantages that are quite similar to a defined contribution pension fund. This is a way to encourage self-employed people to save for retirement but is also used by members of occupational retirement funds who wish to top up their retirement savings with the

added tax benefit. Cameron (2008:48-51) highlights the following main features of this fund:

- benefits are based on contributions plus the investment growth (similar to defined contribution pension fund);
- retirement annuity funds are regulated in terms of the Pension Fund Act (section 4(1));
- on retirement, the employee is entitled to take up to a maximum of one third of the total pension as a lump sum cash payment except where two-thirds of the total value does not exceed R50 000. The third is calculated based on the actual amount accumulated in the employee's fund;
- at least two-thirds of the total pension must be used to provide a monthly pension for life (a compulsory purchase annuity);
- the employee may retire from a retirement annuity fund any time after the age of 55, no matter whether he or she is still working or not. This is different to employer sponsored pension funds where an employee retires from the fund the date the employee retires from his or her job;
- amounts paid into a retirement annuity are not considered as being part of a person's estate should he or she go bankrupt therefore creditors cannot claim this money. This is an important consideration for people who are involved in businesses who provided personal security for a loan to that business; and
- various tax benefits exist (to be discussed in the following chapter).

2.3.5 Preservation funds

Preservation funds are used to "warehouse" a person's retirement savings until retirement. Cameron (2008:51-53) highlights the following main features of this fund:

- there are 2 different preservation funds: pension and provident preservation funds. Transfers from defined benefit pension fund and defined contribution pension funds should be to a pension preservation fund and transfers from a

provident fund should be to a provident preservation fund. The reason for this is that there are different tax treatments for pension and provident funds;

- no tax is payable on the transfer of savings to a preservation fund, but there are costs involved. Costs can be as high as 7% when investing and then a further 2,5% per year thereafter;
- the minimum retirement age from a preservation fund is 55 years of age;
- preservation funds provide a wide choice of investments that are mainly investments in unit trusts or portfolios selected by experts based on risk profiles;
- contributions to a preservation fund should either come from occupational retirement funds or from another preservation fund;
- one withdrawal from each transfer to a preservation fund before retirement is allowed. This withdrawal may only occur after the transfer of the capital to the preservation fund is complete;
- any withdrawals before retirement are subject to tax; and
- amounts in a preservation fund are protected against creditors in the event of sequestration.

2.4 SUMMARY

The important considerations for retirement investment as well as the most commonly used retirement investment vehicles were discussed in this chapter. Hopefully it is clear that investing for retirement is very important and that it is never too late to start investing for retirement.

Before joining a retirement investment fund, or when one considers switching from one type of fund to another, there should be a clear understanding of the differences between the various types of funds and particularly their advantages and disadvantages. Only then is one able to make an informed decision as to which fund is the right fund based on one's own personal circumstances.

Moving onto the next chapter, it deals with another very important consideration in deciding which retirement investment vehicle is to be used. The tax effects of each of the retirement investment vehicles as discussed in this chapter are dealt with and compared with each other.

CHAPTER 3

TAXATION ON RETIREMENT SAVINGS

3.1 INTRODUCTION

Taxation is one of the most important considerations for retirement planning. It plays a significant role in the various stages of retirement planning, whether it is during the pre-retirement/build-up stage, actual retirement stage or the post-retirement stage.

To be able to understand the significance of the provisions of income tax relating to the retirement industry, it is necessary to have a general overview of the principles of the Income Tax Act specifically relating to when income is taxable and what expenses are deductible for tax purposes. After the general overview the tax on retirement savings is discussed specifically pertaining to both the currently-enacted legislation and the newly-proposed legislation as announced by the Minister of Finance during the 2011 Budget Speech.

3.2 GENERAL OVERVIEW OF INCOME TAX

The Income Tax Act contains the legislation relating to the taxation of income (normal tax), donations, capital gains and dividends declared by companies. Income tax is levied on the taxable income of a person. The determination of taxable income is the first step in calculating one's liability for normal tax. According to Stiglingh, Koekemoer, Van Schalkwyk, Wilcocks, De Swardt and Jordaan (2011:1-4), taxable income of a natural person is calculated as illustrated in Table 2:

Table 2: Natural person - Taxable

Gross income (section 1)	Rxxx
Less: Exempt income (section 10 and section 10A)	(Rxxx)
Income	Rxxx
Less: Deductions and allowances (section 11-19, section 21-24N, excluding section 18 and section 18A)	(Rxxx)
Add: Taxable capital gain (section 26A)	Rxxx
	Rxxx
Less: Deductions (section 18 and section 18A)	(Rxxx)
Taxable income	Rxxx

Source: (Stiglingh *et al*, 2011:1-4)

The normal tax liability of a natural person is calculated based on the taxable income according to tax tables as illustrated in Table 3:

Table 3: Natural person - Tax rates 2012

Taxable income		Rates of tax		
R	R	R		R
0 -	150 000		18% of each	1
150 001 -	235 000	27 000 +	25% of the amount above	150 000
235 001 -	325 000	48 250 +	25% of the amount above	235 000
325 001 -	455 000	75 250 +	25% of the amount above	325 000
455 001 -	580 000	120 750 +	25% of the amount above	455 000
580 001	and above	168 250 +	25% of the amount above	580 000

Source: (Section 5 of the Income Tax Act)

A year of assessment for an individual runs from the first day in March to the last day in February of the following year. Natural persons receive rebates (primary and secondary) to be deducted from the normal tax calculated (in terms of section 6 of the Income Tax Act). The primary rebate is available to any taxpayer (natural person) whereas the secondary rebate (in addition to the primary rebate) is available to taxpayers who are 65 years and older on the last day of assessment. (Stiglingh *et al*, 2011:287.)

During the 2011 Budget Speech presented by the Minister of Finance, Pravin Gordhan (Department of National Treasury, 2011:28), a tertiary rebate for natural

persons aged 75 and older was proposed and accepted. This rebate is in addition to the primary and secondary rebate (Section 6 of the Income Tax Act).

These three rebates available to be deducted from the normal tax payable by a natural person may be summarised as follows in Table 4:

Table 4: Natural person - Tax rebates 2012

Primary rebate for natural persons	R10 755
Secondary rebate for natural persons aged 65 and older	R6 012
Tertiary rebate for natural persons aged 75 and older	R2 000

Source: (Section 6 of the Income Tax Act)

After discussing the components of taxable income and the calculation of tax payable on the taxable income, it is very important to discuss both the definition of gross income and the general deduction formula in greater detail. This enables further discussion on amounts to be included as part of gross income (typically the lump sums/annuities received from retirement investment funds) as well as amounts that may be deducted against income received (typically the monthly premiums/payments towards retirement investment funds).

3.1.1 Gross income

The first step in determining taxable income is to determine whether an amount falls into the general definition of gross income. The gross income definition in section 1 of the Income Tax Act have the following requirements or elements (in relation to a year or period of assessment):

- ***In the case of any resident***

the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or

- ***In the case of any person other than a resident***

the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within or deemed to be within South Africa,

Receipts or accruals of a capital nature are specifically excluded from the gross income definition.

The definition then continues with paragraphs (a) through (n), referred to as the specific inclusions. The specific inclusions serve to include certain amounts in gross income whether they are of a capital nature or not and also to act as anti-avoidance measures. They do not, however, limit the scope of the general definition of “gross income” as defined in the Income Tax Act.

South Africa changed from being a source-based tax system to a residency-based system on 1 January 2001. This means that the worldwide income of a South African resident is subject to income tax in the Republic of South Africa, while only income from a South African source is subject to South African income tax in the hands of a non-resident.

A natural person is a resident of the Republic of South Africa for the purposes of section 1 of the Income Tax Act if he or she is ordinarily resident in the Republic or if he or she is a resident by virtue of a physical presence test. The term “ordinarily resident” is not defined in the Act, but in terms of case law it is the place where a person would naturally and as a matter of course return to from his wanderings; as contrasted with other countries it might be called his usual or principal residence and it would be described more aptly than other countries as his real home (*Cohen v CIR*, 1946 AD 174 (13 SATC 362); *CIR v Kuttel*, 1992 (3) SA 242 (A) (54 SATC 298)). Any person other than a natural person is a resident of the Republic if incorporated, established or formed in the Republic or if their place of effective management is in the Republic.

For an amount to fall within the general definition of gross income there should therefore be:

- an amount (in cash or otherwise);
- received by or accrued to;

- during the year of assessment; and
- that is not of a capital nature.

In practice there are various interpretations of this seemingly “simple” definition and have resulted in a number of court cases to clear out and confirm the interpretations and applications thereof.

The following is a very brief summary of the most important cases explaining the principles of the most controversial elements of the definition of gross income:

- **An amount**

“Amount” is not defined in the Act, but the courts have held that it must have an ascertainable money value and if not or cannot be turned into money, it cannot be gross income (*CIR v Butcher Bros (Pty) Ltd*, 1945 AD 301 (13 SATC 21); *CIR v Delfos*, 1933 AD 242 (6 SATC 92)).

- **Received by or accrued to**

An amount is only “received” for the purposes of the gross income definition if it is received by the taxpayer for his/her own benefit or on his/her own behalf (*Geldenhuis v CIR*, 1947 (3) SA 463 (40 SATC 419)). An amount has “accrued” to a taxpayer when he/she becomes unconditionally entitled to it (*Lategan v CIR*, 1926 CPD 203 (2 SATC 16); *CIR v People’s Stores (Walvis Bay) (Pty) Ltd*, 1990 (2) SA 353 (A) (54 SATC 271); *Mooi v SIR*, 1972 (1) SA 675 (A) (34 SATC 1)).

The definition of gross income ends with a proviso stating that where a person becomes entitled to an amount during the year of assessment, which is only payable in a subsequent year, the face value of the amount (i.e. not the present value) is deemed to accrue to that person. This proviso was inserted to counteract the decision of Hefer, JA in *CIR v People’s Stores (Walvis Bay) (Pty) Ltd* where it was held that where a right to receive payment in the future accrued to a taxpayer, that right had to be valued and that value was affected by the lack of immediate enforceability.

- ***During the year of assessment***

An amount is only income in a specific year if that amount has been received by or accrued to a taxpayer during that year of assessment. Each year of assessment stands on its own and therefore the amount can only be subject to tax in that relevant year. (Stiglingh *et al*, 2011:24.)

- ***Capital versus revenue***

The distinction between the capital or revenue nature of receipts or accruals has been the subject of much case law. This distinction has, however, become somewhat less important with the introduction of capital gains tax (CGT) on 1 October 2001. Where previously a capital gain was not taxable, the introduction of CGT now includes a portion (25% for individuals, otherwise 50%) of a capital gain in the taxpayer's taxable income. Receipts and accruals of a capital nature that are not included in gross income through one of the specific inclusions are subject to CGT. CGT is not a separate tax, but rather normal income tax on the taxable portion of a capital gain. A consistently applied test for distinguishing between capital and revenue receipts is the enquiry whether the taxpayer was engaged in a "scheme of profit-making" (*CIR v Pick 'n Pay Share Purchase Trust*, 1992 (4) SA 39 (A) (54 SATC 271)).

Any capital gain calculated in terms of the Eighth Schedule to the Income Tax Act is included in taxable income by section 26A. For there to be a capital gain there must be a "disposal" of an "asset". Both of these terms are defined in paragraph 1 of the Eighth Schedule and are very wide. In addition, there are a number of deemed disposals listed in paragraph 12. The "capital gain" is defined in paragraph three as the amount by which the "proceeds" on disposal exceed the "base cost" of the asset. Both of these terms are also extensively defined in Parts VI and V of the Eighth Schedule of the Income Tax Act.

3.1.2 General deduction formula

A further step in determining the taxable income of a natural person, as indicated in Table 2, is to deduct all amounts allowed to be deducted from income as defined in section 1 of the Income Tax Act.

Section 11 of the Income Tax Act states the deductions allowed in the determination of taxable income. This section should be read together with section 23 that contains certain restrictions on the deductibility of income. The bulk of expenditure deductible against a taxpayer's income is allowed under section 11(a) (known as the "general deduction formula"). This section allows as a deduction from income derived from trade any expenditure and losses actually incurred during the year of assessment in the production of income that is not of a capital nature. In addition, section 23(g) prohibits the deduction of any amount not laid out or expended for the purposes of trade. Paragraphs (b) to (x) of section 11 deals with the deductibility of specific types of expenditure and losses (Huxam & Haupt, 2011:95-96).

Similarly, to the requirements of the gross income definition, there are also different interpretations of the "general deduction formula" which also resulted in numerous court cases. The outcome of the court cases and the application thereof can be summarised as follows:

- **Trade**

"Trade" is defined very widely in section 1 of the Income Tax Act and includes every profession, trade, business, employment, calling, occupation or venture, including the letting of any property and the use of or the grant of permission to use any patent, design, trade mark, any copyright or any other property which is of a similar nature. In *Burgess v CIR*, 1993 (4) SA 161 (A) (55 SATC 185) it is has been confirmed that it should be given its widest possible meaning.

- **Expenditure and losses**

For actual expenditure incurred there were a number of court cases and are dealt with under the next point. The bigger question under scrutiny was what

the definition of losses should be. The court held the loss should be considered in context and that includes losses of floating capital employed in the trade that produces income (*Port Elizabeth Electric Tramway Co Ltd v CIR*, 1936 CPD 246 (8 SATC 13)).

- ***Actually incurred***

An expense is only “actually incurred” if it is not subject to any suspensive or resolutive condition (*Nasionale Pers v KBI*, 1986 (3) SA 549 (A) (48 SATC 55)) and although the quantum of the expense may be uncertain the obligation to pay must be certain (*Edgars Stores Ltd v CIR*, 1988 (3) SA 876 (A) (50 SATC 81)). In *ITC1444* (51 SATC 35) it was held that for an expense to be “actually incurred” there must be an “absolute and unqualified legal liability to pay”.

- ***During the year of assessment***

Although section 11(a) does not specifically require expenditure to be deducted or to be restricted to the year of assessment in which it was incurred, the courts confirmed it as such (*Concentra (Pty) Ltd v CIR*, 1942 CPD 509 (12 SATC 95)). The general principle is therefore that if a deduction is not claimed in the correct year of assessment, the deduction may not be claimed in subsequent years (*Stiglingh et al*, 2011:113).

- ***In the production of income***

For an expense to be incurred “in the production of income” the act to which the expenditure is attached must be performed bona fide for purposes of carrying on the trade that produces the income and the expense should be so closely linked to this act that it may be regarded as part of the cost of performing it. If this is satisfied, then it does not matter whether the expense is necessary, incurred by chance or for improving efficiency (*Port Elizabeth Electric Tramway Co Ltd v CIR*, 1936 CPD 246 (8 SATC 13)). The closeness of the connection between expenses and the income earning operations should be assessed having regard for both the purpose of the expenditure and what it actually affects (*CIR v Nemojim (Pty) Ltd*, 1983 (4) SA 935 (A) (45 SATC 241)). It is important to note that it is irrelevant whether the expenditure actually produced income as long as it was incurred for the purposes of producing income (*Sub-Nigel Ltd v CIR*, 1948 (4) SA 580 (A) (15 SATC 381)).

- **Capital versus revenue**

Expenses of a capital nature are not deductible in terms of the general deduction formula. Certain capital expenses are, however, allowed as deductions for CGT purposes due to it forming part of the base cost of an asset. In addition, specific provisions of the Income Tax Act such as those contained in sections 11(e), 12B and 12C grant certain capital allowances. The courts have developed separate principles for evaluating the capital or revenue nature of expenditure compared to gross income. Money spent in creating or acquiring an income producing concern or a source of future profit is capital (the outlay does not recur while the income does) and money spent working that source is revenue (*CIR v George Forest Timbers Co Ltd*, 1924 AD 516 (1 SATC 20)).

Expenditure incurred in establishing, improving or adding to the equipment of the income-producing structure is capital, whereas expenditure incurred as part of performing the income-producing operations is revenue. When the capital employed in a business is frequently changing its form from money to goods and vice versa, and this is done for the purpose of making a profit, capital so employed is floating capital which is deductible (*New State Areas Ltd v CIR*, 1946 AD 610 (14 SATC 155)). The English courts have also developed what is known as the “enduring benefit” test. In *British Insulated Helsby Cables v Atherton*, 1926 AC, it was said that when expenditure incurred not only once and for all but also with a view to bringing into existence an asset or advantage for the enduring benefit of a trade, there is good reason for treating such expenditure as capital.

3.1.3 Lump sum benefits

Lump sum benefits from retirement funds are generally of a capital nature and should therefore be excluded from gross income unless specifically included. Paragraph (e) of the “gross income” definition includes in a taxpayer’s gross income any amount determined in accordance with the Second Schedule to the Income Tax Act in respect of lump sum benefits received by or accrued to such person from or

in consequence of his membership or past membership of any pension, provident or retirement annuity fund approved by the Commissioner if such person was a member or past member of such a fund.

Paragraph 1 of the Second Schedule to the Income Tax Act defines a lump sum benefit as:

- an amount determined by the commutation of an annuity or portion of an annuity; and
- any fixed or ascertainable amount other than an annuity payable by or provided in consequence of membership or past membership of a fund whether in one amount or in instalments, other than any amount deemed to be income accrued to a person in terms of a maintenance order. (Stiglingh *et al*, 2011:357-358.)

A lump sum benefit as defined in the Second Schedule to the Income Tax Act (which is a benefit from a pension fund, pension preservation fund, provident fund, provident preservation fund and RAF) is exempt from capital gains tax in terms of paragraph 54 of the Eighth Schedule to the Income Tax Act. Paragraph 54 of the Eighth Schedule also exempt any lump sum benefit from a fund, arrangement or instrument situated outside the Republic of South Africa that provides similar benefits under similar conditions to an approved pension, provident or retirement annuity fund.

3.2 TAX ON RETIREMENT SAVINGS – CURRENT LEGISLATION

Although employment is included in the definition of a trade in section 1 of the Income Tax Act, section 23(m) still limits the deductions a salaried employee may claim against his income. The section prohibits the deduction of any expenditure, loss or allowance relating to any employment of, or office held by any person (other than an agent or representative whose remuneration is normally derived mainly in the form of commissions based on his or her sales or the turnover attributable to him or her) in respect of which he or she derives any remuneration, as defined in paragraph

1 of the Fourth Schedule to the Income Tax Act. Section 23(m), however, lists certain exceptions to this, amongst which the contributions made by an employee to a pension fund (defined benefit fund or defined contribution fund) or retirement annuity fund are deductible in terms of sections 11(k) and 11(n) respectively.

On the other hand, employers who contribute to an employee's retirement saving (pension fund, provident funds and RAF) can claim a deduction of contributions up to 20% of the employee's retirement funding income against their taxable income in terms of section 11(l).

3.2.1 Contributions to defined contribution provident fund

Contributions to a provident fund are not deductible against taxable income. There is, however, a way of deferring tax until one retires. Contributions made by the employer towards a provident fund are tax deductible by the employer. The employer should therefore pay all the contributions directly on the employee's behalf by means of a salary sacrifice which effectively means that the employee receives a lower cash salary every month, potentially has a lower income tax marginal rate and pays less tax while still deferring tax until the day one retires (Cameron, 2008:157).

Care should be taken when setting up these schemes to ensure that SARS cannot attack the scheme under the impermissible tax avoidance arrangements as contained in sections 80A through to section 80L. The Commissioner has identified a number of factors that are considered in assessing the validity of a salary restructure. A *bona fide* salary sacrifice would have the effect of decreasing, amongst others, the employee's entitlement to leave and bonus payments, decreased UIF and pension fund contributions. It is very important that the employee is completely divested from the liability to pay the contributions to the provident fund; therefore the situation should be avoided where the amount accrues to the employee who then has the liability to pay the contribution to the fund. Instead, the liability to make the contribution should be that of the employer. It is

therefore of utmost importance to distinguish between a disposal of income to the fund after it has accrued to the employee and a disposal of a right to receive income in the future.

At retirement, the entire benefit from a provident fund may be taken as a lump sum. One's own contributions are paid out tax-free whereas the employer contribution and the entire investment growth are subject to tax. According to section 6(1), the taxable portion is taxed as follows:

- the first R315 000 is tax free;
- the second R315 000 is taxed at 18%;
- the third R315 000 is taxed at 27%; and
- any amount above R945 000 is taxed at 36%.

3.2.2 Contributions to defined benefit pension fund and defined contribution pension fund

In the case of a member's contribution to a pension fund, the deduction is limited (in terms of section 11(k)) to the greater of:

- R1 750; or
- 7,5% of his income from "retirement-funding employment".

Retirement-funding employment is defined in section 1 of the Income Tax Act and it basically means that part of the employee's income that is taken into account in the determination of the contributions made by him/her or on his/her behalf to a pension or provident fund. Income from retirement funding employment is normally also referred to as pensionable salary/income.

Section 11(k) also allows a R1 800 deduction for any past service contribution (arrear contributions) made by the member to the pension fund. Unlike current service contributions, past service contributions towards a pension fund in excess of

the R1 800 may be carried forward to a subsequent year of assessment again subject to the limit.

Current contributions to a pension fund in excess of the deduction allowed by section 11(k) may not be carried forward to the subsequent year of assessment. Any contributions not allowed as a deduction in terms of section 11(k) increase the tax-free portion of the lump sum benefit upon retirement, death or withdrawal.

At retirement the taxpayer must use at least two-thirds of the total amount to purchase a monthly pension that is taxed when it is received at the taxpayer's marginal rate of tax, unless the amount available to buy a pension is less than R50 000 in which case the total amount may be withdrawn. According to section 6(1), the portion taken as a lump sum is taxed as follows:

- the first R315 000 is tax free;
- the second R315 000 is taxed at 18%;
- the third R315 000 is taxed at 27%; and
- any amount above R945 000 is taxed at 36%.

The tax-free amount of R315 000 is cumulative over the lifetime of the taxpayer for retirement fund lump sums received. Taxpayers that are members of more than one retirement fund may, however, benefit by retiring in different years of assessment, thereby taking advantage of the lower rate of tax on the first and second increments of R315 000 more than once. This is due to the fact that first and second increments of R315 000, which have a low rate of tax, are not cumulative/limited over the lifetime of the taxpayer as in the case of the tax-free amount.

3.2.3 Contribution to retirement annuity fund

Section 11(n) limits the deduction of retirement annuity fund (RAF) contributions to the greater of:

- 15% of the taxpayer's non-retirement funding taxable income (allowances such as housing allowance, car allowance and overtime);
- the amount by which R3 500 exceeds any deduction allowed under section 11(k)(i) which is the pension fund contributions; or
- R1 750.

Re-instatement contributions (arrear contributions) towards a RAF are also subject to a R1 800 deduction limit and may also be carried forward.

Excess contributions to a RAF may, however, be carried forward to, and deducted in the subsequent year of assessment again subject to the limits of section 11(n). Any contributions not allowed as a deduction in terms of section 11(n) increase the tax-free portion of the lump sum benefit upon retirement, death or withdrawal.

At retirement the taxpayer must use at least two-thirds of the total amount to purchase a monthly pension, which is, taxed when it is received at the taxpayer's marginal rate of tax, unless the amount available to buy a pension is less than R50 000 in which case the total amount may be withdrawn. According to section 6(1), the portion taken as a lump sum is taxed as follows:

- first R315 000 is tax free;
- the second R315 000 is taxed at 18%;
- the third R315 000 is taxed at 27%; and
- any amount above R945 000 is taxed at 36%.

The tax-free amount of R315 000 is cumulative over the lifetime of the taxpayer for retirement fund lump sums received. Taxpayers that are members of more than one retirement fund may, however, benefit by retiring in different years of assessment, thereby taking advantage of the lower rate of tax on the first and second increments of R315 000 more than once. This is because the first and second increments of R315 000, which have a low rate of tax, are not

cumulative/limited over the lifetime of the taxpayer as in the case of the tax-free amount.

Considering the requirements of the general deduction formula (section 11(a)), it should be noted that in the case of an individual that earns income outside of employment (e.g. business or investment income) to which the limitations of section 23(m) do not apply, a section 11(a) deduction is not allowed for the portion of the RAF contribution exceeding the deduction allowed by section 11(n). This is because of section 23B(3) that disallows any deduction in terms of section 11 (a) in respect of any expenditure or loss of a type for which a deduction or allowance is granted under any other provision of the Income Tax Act, even though such other provision limits the amount of such deduction.

Even in the absence of section 23B(3), contributions to a retirement fund might not be deductible in terms of section 11(a), as these contributions are most probably of a capital nature because it is indicative of the accumulation of the base of funds from which a pension is derived upon retirement. It is therefore adding to the income producing structure rather than being incurred as part of performing the income-producing operations (capital versus revenue arguments).

3.3 TAX ON RETIREMENT SAVINGS – NEW PROPOSED LEGISLATION

During the 2011 budget speech presented by the Minister of Finance, Pravin Gordhan, a number of changes to the tax treatment and administration of contributions to retirement funds were proposed. The proposals include the following (Department of National Treasury, 2011:28-29):

- any contributions made by an employer to any retirement fund on their employees' behalf are treated as a taxable fringe benefit;
- limits on tax deductible contributions where employees are allowed to deduct up to 22,5% of taxable income for contributions to approved retirement funds (pension funds, provident funds and RAF);

- a maximum of R200 000 a year is deductible against taxable income for contributions to approved retirement funds;
- in cases where 22,5% of taxable income is calculated at less than R12 000, a taxpayer is able to deduct contributions up to R12 000; and
- one-third lump-sum withdrawal limit applicable to pension and retirement annuity funds should also apply to provident funds. (Department of National Treasury, 2011:29.)

According to Nathan (2011:1), these proposals will have the following impact on taxpayers:

- the limitation on the retirement fund deductions will adversely impact high earners (typically people taxed at the marginal rate of tax) who make major contributions to their funds since it limits their savings potential;
- deductions are now available to people contributing towards provident funds; and
- the withdrawal limit on provident funds will help to preserve retirement savings.

Jones (2011b:1) also highlights that these proposals are likely to reduce take-home pay for mega-earners who currently enjoy membership of retirement funds whose aim is to defer payment of tax until retirement. The amounts contributed in excess of the proposed maximum limit of R200 000 a year are not deductible for tax purposes in the year that the amounts are contributed towards the retirement fund, but will probably be paid out tax free on retirement (only the capital contributions and not the growth which will be taxed).

Jones (2011b) illustrates the potential impact of the changes as follows, assuming the following facts (Table 5):

- employee earns an annual package of R600 000;
- employee is a member of a pension fund (employee and employer contribute both 7,5% to the pension fund);

- assume the full remuneration package is pensionable and the taxpayer contributes the full amount allowable as a deduction into a RAF; and
- salary structuring has been excluded from the example.

Table 5: Example: Contribution to both pension fund and RAF

	Current rules	New rules
Annual package	R600 000	R600 000
Employer contribution to pension fund (7,5%) – fringe benefit	R0	R45 000
Less: Allowable deduction for pension fund contributions	(R45 000)	(R90 000)
Taxable income (before allowable RAF contributions)	R555 000	R555 000
Less: Allowable deduction for RAF contributions	(R1 750)	(R45 000)
Taxable income (after allowable RAF contributions)	R553 250	R510 000
Tax saving as from 1 March 2012		R16 435

Source: (Jones, 2011b)

Using the same assumptions as above but changing the contribution to a provident fund instead of a pension fund the potential impact of the changes are as follows (Table 6):

Table 6: Example: Contribution to both provident fund and RAF

	Current rules	New rules
Annual package	R600 000	R600 000
Employer contribution to provident fund (7,5%) – fringe benefit	R0	R45 000
Less: Allowable deduction for provident fund contributions	(R0)	(R90 000)
Taxable income (before allowable RAF contributions)	R600 000	R555 000
Less: Allowable deduction for RAF contributions	(R1 750)	(R45 000)
Taxable income (after allowable RAF contributions)	R598 250	R510 000
Tax saving as from 1 March 2012		R33 535

Source: (Jones, 2011b:1-2)

Finally, assuming that the person is self-employed and not a member of any employer operated retirement fund, the potential impact of the changes are as follows (Table 7):

Table 7: Example: Contribution to RAF – self employed

	Current rules	New rules
Annual package	R600 000	R600 000
Taxable income (before allowable RAF contributions)	R600 000	R600 000
Less: Allowable deduction for RAF contributions	(R90 000)	(R135 000)
Taxable income (after allowable RAF contributions)	R510 000	R465 000
Tax saving as from 1 March 2012		R17 100

Source: (Jones, 2011b)

These examples illustrate that the tax savings under the new rules put more money in lower income earners' pockets (for the purpose of this document lower income earners are defined as taxpayers whose deductions on contributions are not limited to R200 000 – typically taxpayers whose income is less than R888 889) and potentially have the desired outcomes as envisaged by the Minister of Finance, which is to have greater equity between different taxpayers.

The Draft Taxation Laws Amendment Bill, 2011 (“the TLAB”) was released by National Treasury on 2 June 2011 for public comment. The TLAB includes some of the most significant and far reaching amendments to the Income Tax Act of recent years, with a strong focus on tax avoidance and tax planning, particularly in the finance sector. The TLAB was, however, silent on the proposals made by the Minister of Finance with regard to the tax treatment and administration of contributions to retirement funds.

3.4 CONCLUSION

Income tax is part of most people’s lives at one stage or the other, whether you are earning interest, earning a salary, even when you are retired and earning a pension. It is therefore imperative that each taxpayer has a brief understanding of what income consists of, what can be deducted against income received, and how tax then be calculated on a taxpayer’s taxable income. In having an understanding of the principles of income tax, equips people to plan for retirement and create an efficient

tax structure. There are many legitimate ways to save tax. You just need to know about them.

Tax is one of the considerations when making a decision in which retirement investment vehicle one should invest. It should, however not be the only consideration but should play a big role in deciding which one to choose. Smart investments could not only reduce one's taxable income significantly by applying the relevant sections in the Income Tax Act as deductions against income earned, but could also result in additional amounts being available for investment purposes.

CHAPTER 4

COMPARISON OF FUNDS

4.1 INTRODUCTION

From the research performed it is clear that planning for retirement and making the correct retirement investment decisions is not the easiest thing to do. It is more about considering personal circumstances, the advantages and disadvantages of the investment vehicles discussed, the tax effects of each decision and finally changes in legislation and their effect on future decision making.

This research is not aimed at making everyone a financial advisor. Instead it should assist taxpayers to understand and assess their requirements and empower them to ask the right questions of a financial advisor and lastly to understand the advice given.

Remember that no one can predict what the future holds for us. Often very good investment intentions may need to be altered because of unforeseen emergencies and circumstances (including changes in tax legislation). Even the best made plans often have to change. (Hirsch, 2005:51.)

This again highlights the importance of having a financial plan and strategy and to revisit it regularly as and when circumstances change.

To conclude one has to revisit the research objectives that are:

- to critically evaluate the various retirement investment options as savings tools; and
- to provide a guideline for understanding the Income Tax Act as a preamble to analysing the various retirement investment options as tax-planning tools based on current and newly-proposed legislation.

4.2 RETIREMENT INVESTMENT OPTIONS AS SAVINGS TOOLS

After discussing the most commonly used retirement tools, it should be evident that one's decision will be based on personal circumstances. All three retirement options discussed (pension funds, provident funds and RAF) have their own set of advantages, but also their disadvantages.

One should consider the following factors when making retirement investments:

- one's current age together with the age up to which one is prepared to work which will at least give an indication of the period in which one will have to provide for retirement;
- the quality of life envisaged after retirement and by deciding on that, understand the investment required to achieve that goal within the time span as calculated under the previous point;
- consider one's personal circumstances, including whether one is self employed or is working for a company providing a pension or provident fund where membership is compulsory;
- for self-employed people, retirement annuity might be a better option as the total contributions have to come from oneself, it provides a lump sum and an annuity at retirement which can be any time after the age of 55, even though one may continue work (not being retired). Amounts paid into retirement annuities are not considered as part of one's estate should one go bankrupt;
- employees who belong to employer-sponsored funds (pension or provident) may consider maximising employer contributions, even though it might mean an additional own contribution. One should also consider to top up the investment by means of a retirement annuity fund;
- understand the policy entered into and consider the risks associated. One normally has choices regarding the risk profiles of each investment – consider and decide carefully. The closer to retirement, the more conservative the risk profile should be;
- avoid unnecessary resignations/movements between funds. There are always cancellation costs involved and one may even lose a significant percentage of the amounts invested;

- cash flow required at retirement – lump sum with a monthly annuity is achieved through pension funds and retirement annuity funds or only a lump sum by means of provident funds; and
- finally, consider the above with the added tax benefits that are on offer.

The main features of the different investment options as retirement tools are summarised in Table 8.

Table 8: Comparison of investment options

	Pension fund	Provident fund	Retirement annuity fund
Investment risk	<i>Defined benefit pension fund</i> – the employer carries the risk <i>Defined contribution fund</i> – the employee carries the risk	The employee carries the risk	The taxpayer/investor carries the risk
Contributions	Both the employee and the employer contribute towards the fund	Both the employee and the employer contribute towards the fund	The taxpayer/investor carries the risk
Group life assurance	Yes – part of the fund	Yes – part of the fund	No – not specifically part of the fund
Lump sum payments	Up to a maximum of 1/3 of the total investment is available as a lump sum payment, unless the remaining 2/3 of the total investment is less than R50 000 in which case the total amount may be withdrawn	Total investment is available as a lump sum payment. Option is available to take less and purchase an annuity	Up to a maximum of 1/3 of the total investment is available as a lump sum payment, unless the remaining 2/3 of the total investment is less than R50 000 in which case the total amount may be withdrawn
Compulsory purchase annuity	The remaining 2/3 of the total investment must be used to provide for a monthly pension for life	Applicable if the total investment is not taken as a lump sum payment	The remaining 2/3 of the total investment must be used to provide for a monthly pension for life
Tax benefits available	Yes–refer to chapter 4.3 for the summary	Yes – refer to chapter 4.3 for the summary	Yes – refer to chapter 4.23for the summary

4.3 RETIREMENT INVESTMENT OPTIONS AS A TAX PLANNING TOOL

One should always take care not only to consider the most efficient tax option when making retirement investment decisions, however, the tax effect on both the monthly contributions as well as on retirement (lump sum) should be an important consideration.

The tax effect of each option discussed (pension funds, provident funds and RAF) during the investment phase is summarised in Table 9.

Table 9: Tax during investment period

Pension funds	Provident funds	Retirement annuity funds
Current legislation		
Deduction is the greater of: <ul style="list-style-type: none"> - 7,5% of remuneration from retirement funding employment, or - R1 750 	No deduction available	Deduction is the greater of: <ul style="list-style-type: none"> - 15% of income other than from retirement funding employment, or - R3 500 less pension fund contributions, or R1 750
Newly proposed legislation		
<ul style="list-style-type: none"> • Deductions up to 22,5% of taxable income for contributions to approved retirement funds (pension funds, provident funds and RAF); • A maximum of R200 000 a year is deductible against taxable income for contributions to approved retirement funds; • In cases where 22,5% of taxable income is calculated at less than R12 000, a taxpayer is able to deduct contributions up to R12 000. 		

To illustrate the current legislation and the potential impact of the proposed changes on high-income earners, assume the following facts:

- an employee earns a retirement funding income (pensionable salary) of R800 000;
- an employee earns a further non-retirement funding income R200 000;
- an employee is a member of a pension fund (employee contributes 7,5% and employer contributes 15% to the pension fund – total contribution is 22,5%);
- an employee is a member of a RAF and contributes R40 000; and

- salary structuring has been excluded from the example.

Table 10: Example: High-income earners' contribution to both pension fund and RAF

	Current rules	New rules
Retirement funding income	R800 000	R800 000
Non-retirement funding income	R200 000	R200 000
Employer contribution to pension fund (15%) – fringe benefit	R0	R120 000
Less: Allowable deduction for pension fund contributions	<u>(R60 000)</u>	<u>(R180 000)</u>
Taxable income (before allowable RAF contributions)	R940 000	R940 000
Less: Allowable deduction for RAF contributions	<u>(R30 000)</u>	<u>(R20 000)</u>
Taxable income (after allowable RAF contributions)	R910 000	R920 000
Tax on taxable income	<u>(R300 250)</u>	<u>(R304 250)</u>
Tax saving/(loss) as from 1 March 2012		(R4 000)

From this example it is clear that the higher income taxpayer is adversely impacted by the newly-proposed legislation. The deduction of contributions to retirement funds is limited to R200 000 (resulted in R20 000 of the RAF contribution not allowed as a deduction) whereas the limitation on the current legislation is less (only R10 000 not allowed, as the deduction was limited to 15% of non-retirement funding income).

To illustrate the current legislation and the potential impact of the proposed changes on lower income earners, assume the following facts:

- an employee earns a retirement funding income (pensionable salary) of R400 000;
- an employee earns a further non-retirement funding income R100 000;
- an employee is a member of a pension fund (employee contributes 7,5% and employer contributes 15% to the pension fund – total contribution is 22,5%);
- an employee is a member of a RAF and contributes R30 000; and
- salary structuring has been excluded from the example.

Table 11: Example: Lower income earners contribution to both pension fund and RAF

	Current rules	New rules
Retirement funding income	R400 000	R400 000
Non-retirement funding income	R100 000	R100 000
Employer contribution to pension fund (15%) – fringe benefit	R0	R60 000
Less: Allowable deduction for pension fund contributions	<u>(R30 000)</u>	<u>(R90 000)</u>
Taxable income (before allowable RAF contributions)	R470 000	R470 000
Less: Allowable deduction for RAF contributions	<u>(R15 000)</u>	<u>(R30 000)</u>
Taxable income (after allowable RAF contributions)	R455 000	R440 000
Tax on taxable income	<u>(R120 750)</u>	<u>(R118 950)</u>
Tax saving/(loss) as from 1 March 2012		R1 800

This example confirms that lower income taxpayers are favourably impacted by the newly-proposed legislation. The deduction of contributions to retirement funds is seldom limited as these taxpayers have reduced contributions towards retirement investment funds. The current legislation, however, still limits deductions against taxable income for contributions made towards a RAF as the deduction will be the greater of 15% of non-retirement funding income, R3 500 less pension fund contributions or R1 750 (in this example 15% of non-retirement funding income).

The impact of the newly proposed legislation is very favourable for taxpayers contributing toward a provident fund during the investment phase as the current legislation does not allow a deduction against taxable income whereas the newly-proposed legislation allows contributions as a deduction. This means that a taxpayer contributing towards a provident fund could get a tax deduction up to R200 000 depending on the limit to the contributions made. The contrary is also true. The lump sum benefit at retirement would be subject to tax according to the new legislation whereas currently only the investment growth would be subject to tax

In addition to these 2 extensive examples and summaries of current and proposed legislation, Table 5 to Table 7 provide additional examples on the application of the tax legislation (for pension funds, provident funds and RAF) as well as the tax effect on each investment option.

Further to the initial tax savings during the investment phase, one should also keep in mind that tax is levied at retirement on the lump sum payment. The tax effect thereof is explained in Table 12.

Table 12: Tax at retirement on lump sum

Pension fund and retirement annuity fund				Provident fund
Current legislation				
Taxable income (R)		Rates of tax		Amount not taxable as there was no deduction available during the investment period
0 -	315 000		0% of amount	
315 001 -	630 000	R0 +	18% of the amount above R315 000	
630 001 -	945 000	R56 700 +	27% of the amount above R630 000	
945 001 and above		R141 750 +	36% of the amount above R945 000	
Newly- proposed legislation				
One-third lump-sum withdrawal limit applicable to pension and retirement annuity funds should also apply to provident funds at the same rates as above.				

Tax consequences are far reaching and consideration should be given not only to the current normal tax payable on monthly income received but also to annuities and lump sum payments at retirement as well as the possible impact of estate duty and capital gains tax.

4.5 CONCLUSION

Looking at the 3 retirement investment options (pension funds, provident funds and RAF) discussed and compared in this chapter, as both a savings and tax planning tools, the following should be considered when making an investment decision:

- pension funds and provident funds are very similar during the investment/contribution phase with the exception of the fact that no tax deduction is allowed during this phase for provident fund contributions (currently enacted tax legislation). Both the pension funds and provident funds

usually provides group life insurance and the contributions towards these funds are normally made by both the employer and the employee;

- RAF are usually used by people who are self employed or as a top up investment in addition to his/her pension fund and/or provident fund contributions/investments;
- pension funds and RAF are similar from a tax point of view (currently enacted tax legislation) where both enjoy a deduction against taxable income for amounts invested; and
- pension funds and RAF are similar at retirement where a lump sum payment, up to a third of the investment, will be available with the balance been paid as an annuity. With a provident fund the total amount invested will be paid out as a lump sum with the option to utilise some or all the funds to purchase an annuity.

The newly-proposed tax legislation will however simplify matters in such a way that all retirement investment contributions (to pension funds, provident funds and RAF) will have up to a 22,5% deduction against taxable income (deduction limited to actual amount contributed up to a maximum of R200 000). At retirement the one third lump sum payment limit will not only apply to pension funds and RAF, but also to provident funds.

CHAPTER 5

CONCLUSION

5.1 INTRODUCTION

This research is not aimed at making everyone a financial advisor. Instead it should assist taxpayers to understand and assess their requirements and empower them to ask the right questions of a financial advisor and lastly to understand the advice given.

Remember that no one can predict what the future holds for us. Often very good investment intentions may need to be altered because of unforeseen emergencies and circumstances (including changes in tax legislation). Even the best made plans often have to change. (Hirsch, 2005:51.)

5.2 RESEARCH OBJECTIVES

The study was focused on the following research objectives:

- to critically evaluate the various retirement investment options as savings tools. This was discussed in chapter 2 and compared, summarized and concluded on in chapter 4; and
- to provide guidelines for understanding the Income Tax Act as a preamble to analysing the various retirement investment options as tax planning tools based on current and newly-proposed legislation. This was discussed in chapter 3 and compared, summarized and concluded on in chapter 4.

5.3 FINDINGS

With all this information in mind, it is clear that making the correct investment choice could be very advantageous and could maximise the amount available for retirement. In making investment decisions one has to take into account one's personal

circumstances and consider each available option's advantages and disadvantages. Everyone's personal circumstances are different; therefore, the worst thing that can happen is to take the advice of the employee next to you or the person living next door (probably based on their personal circumstances).

One has to remember to ask about all the facts of the various funds and the choices available within each fund. The detail of the funds can be obtained directly from the fund and/or from one's employer. Also remember to ask a financial advisor for further assistance and plan for retirement!

5.4 RECOMMENDATIONS FOR FUTURE STUDIES

This study discusses the most commonly-used retirement investment vehicles as both investment as well as tax-planning tools. Tax planning does, however not start at the deductions available during the investment phase, and also does not end at the lump sum payment tax deductions available. Tax planning goes much further and could include the following:

- tax during retirement (social grants available and investing for an income);
- estate planning;
- capital gains tax; and even
- healthcare at retirement.

It would therefore be prudent for someone to address these areas in future studies to expand on the concept of tax planning.

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