FOR INTERMEDIARIES

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Retirement annuities remain tops when saving for retirement

Both retirement annuities (RA) and tax-free savings accounts (TFSA) earn tax-free investment returns. However, an RA defers income tax to the post-retirement phase whereas with a TFSA, income tax is paid before every contribution is made.

		RA	TFSA
	Contributions	Tax-deductible	Non tax-deductible
	Investment earnings	Tax-free	Tax-free
	Regular income in retirement	Taxed at marginal tax rate	Tax-free

When saving for retirement, **should a TFSA be used instead of an RA?**

Let's use an example to show what the numbers show us about which product gives a higher after-tax income in retirement.

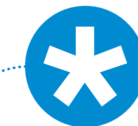
A client with a pre-retirement marginal income tax rate of 45% invests R2 750 per month into a TFSA. This client's equivalent pre-tax contribution to an RA is R5 000 per month[1]. The investment term for both products is 15 years[2].

If we use an investment return of 6% per annum (after costs), the fund values of the TFSA and the RA are R792 900 and R1 441 500, respectively.

Now, although the fund value of the RA is higher, the client will still need to pay tax on the income drawn from the RA in retirement whereas income drawn on the TFSA is tax-free.

Therefore the client's income tax rate post-retirement, and whether he utilizes his tax-free lump sum allowance on retirement, will also impact on the numbers. We have used three scenarios to assess this.

1. *The RA contribution of R5 000 p.m. is calculated as 2750/(1-0.45).*
2. *Over the term of the investment the client contributes a fixed monthly amount of R5 000 and R2 750, respectively.*



Note that this article only considers the numerical differences between an RA and a TFSA.

There are however other factors to also consider when deciding between which savings product to use – among others:

Estate Duty

RAs are exempt from estate duty. On death of the RA member any proceeds paid to dependents or beneficiaries fall outside of the member's estate. This does not apply to TFSA's.

Liquidity

A TFSA offers access to savings at any time. Savings held in an RA can only be accessed from age 55 onwards.

Asset allocation

An RA needs to comply with Regulation 28 of the Pension Funds Act, which limits the range of assets that can be held in a members fund. Although a TFSA has fewer asset class restrictions, it does not allow investment funds with performance fees.

scenario

	A	B	C
Income tax rate pre-retirement	45%	45%	45%
Income tax rate post-retirement	45%	45%	30%
Utilizes tax-free lump sum at retirement	No	Yes	Yes
TFSA fund value	R 792 900	R 792 900	R 792 900
Income in 1st year (tax-free)	R 39 600	R 39 600	R 39 600
RA fund value	R 1 441 500	R 1 441 500	R 1 441 500
Income in 1st year	R 72 000	R 72 000	R 72 000
Tax payable	R 32 400	R 21 600	R 14 400
Net income	R 39 600	R 50 400	R 57 600
Extra income from RA in 1st year	0%	27%	45%

Assumptions

The client retires at age 65 and draws an income of 5% p.a. In scenarios B and C we assume that the lump sum is invested in a discretionary LISP and that the interest exemption of R34 500 (which is assumed to be frozen at this level) is used to offset any interest income earned on this investment.

These numbers only show the financial benefit of an RA over a TFSA in the 1st year of retirement. In practice the gap will continue to widen in future years.

The financial benefit of an RA over a TFSA is also independent of the contribution amount and the tax rates used.

In conclusion

An RA gives the same or better value at retirement compared to a TFSA due to the numerous post-retirement tax-benefits available to individuals who save through an RA. These include:

- Lump-sum tax-free allowance of up to R500 000 on retirement
- Primary plus secondary income tax rebate of R21 114 (2017 – 2018 tax-year)
- In general, a lower marginal tax-rate post-retirement compared to pre-retirement

This article is part of Sanlam's on-going support to intermediaries. It does not constitute advice by Sanlam.