# GAP CAPITAL

Exclusive Offshore Investing

## Living Annuity
## Worked Example

# Understanding Life and Living Annuities

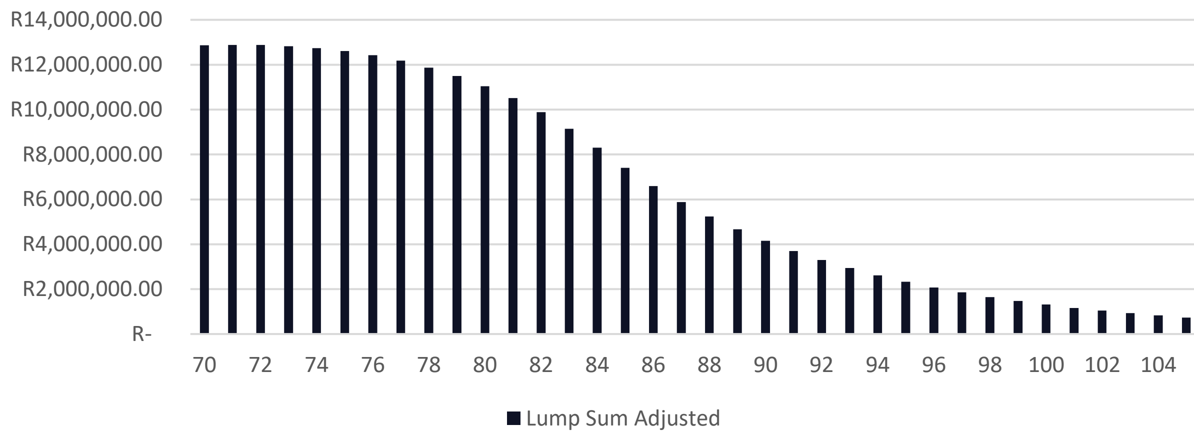
A Life or Living annuity is a well-recognised pension structure, whereby an individual has come to an age whereby they wish to retire. Typically, lump-sum investments like cash, unit trusts, retirement annuities and preservations plans are used to purchase a Life or Living Annuity plan from a reputable provider.

There are however some differences between Living and Life Annuities, the major details of which our outlined in more detail below.

A Life Annuity is a policy you purchase from an approved local provider, whereby the individual uses his accumulated retirement savings to purchase a fixed income for life. This income is usually paid on a monthly basis and increases on the anniversary of the policy by an inflation linked amount (usually between 3 to 5%). This type of product will continue paying an annuity for as long as the policy holder is alive, however on death, whatever may have been left in the policy cannot be left to your next of kin or beneficiaries. There is normally a caveat with most providers that says that the policy agrees to pay out 10 years' worth of annuity payments to beneficiaries if the main policies holder dies prior the 10-year anniversary. However, after that any funds that may have been left in the policy are not returned to the beneficiaries but are for the benefit of the service provider.

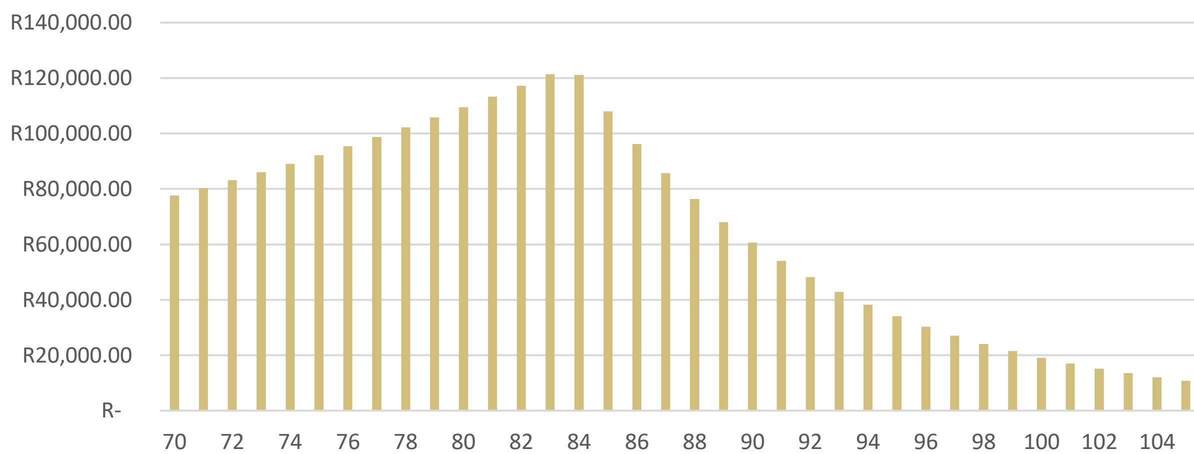
A Living Annuity works slightly differently. With a Living Annuity, you purchase a policy with the funds you have saved up for retirement, in most instances from retirement Annuities and Preservation Funds. Here your funds can continue to grow in the market, and you get to dictate how much of the funds you wish to withdraw on an annual basis. You may elect to withdraw as a minimum 2,5% of the fund value or a maximum of 17,5% of the fund value. You may elect to change the withdrawal amount percentage once a year, on the anniversary of the policy. The reason for this being that 5% of a fund value of R10m would not give you the same living income as 5% of a fund value worth R9m. Therefore, provided your investments outperform your drawdowns your fund value will not decrease in size. However, if your drawdown amounts exceed the growth in the fund then you start to erode your capital. Therefore, investing wisely is paramount to the success of a Living Annuity. You need to factor in inflation into your drawdown calculations when figuring out how long your finds might last for.

To illustrate the point, let us assume an individual has R20m to purchase a living annuity. Let's use inflation at 3% and the client needs a monthly income in today's terms of R50,000.00 to live comfortably. To get a net income after tax of R50,000.00 we need to withdraw roughly R70,000.00 from the Living Annuity. This means an annual withdrawal of R840,000.00 a year or 4.2% of the R12.5m investable funds. Let us further assume we get an average growth of 7% on the R12.5m. If we had to plot a graph and remembering we are limited to drawing down a maximum of 17.5% of the fund annually, this is what the graph looks like.




As you can see the money never runs out. This is because you can only ever draw 17,5% of the fund value in any one year. The only time you can completely close a Living annuity is when the fund value reaches R75,000 or less.

What is more important is to understand, is that at a point in time, the monthly cost of living that you stipulated can no longer be serviced by drawing the maximum of 17,5% from your Living Annuity. In this example this is represented by the following graph.




In this example we can see that, an individual who retired at age 65 and draws down R70,000.00 a month (around R50,000 after tax) and increasing the drawdown with inflation at 4,5% will manage to continue his R50,000.00 lifestyle up to age 77, at which point his monthly income drops, owing to the 17,5% maximum limit you can withdraw.

It is crucial that people who do wish to take out a living annuity understand the impact their drawdown's will have on their investments.

Although it may appear that Living Annuities are scary structures and not as beneficial. You must understand that the above graphs and pictures can change drastically depending on the returns you get. Also, important to understand, is the fact that Living Annuities are not subject to Regulation 28 of the Pension Fund Act, and as such can increase their offshore exposure significantly. Furthermore, Living Annuities can be left to beneficiaries who will continue to derive benefit from the investment fund until such time as it expires. It is therefore extremely important to ensure you have a competent investment professional advising you on how best to invest your Living Annuity funds.

By in large, most pension fund structures are setup as Living Annuities and the major reason for this has to do with probate on death and the ability to leave undistributed funds to beneficiaries. Where you have nominated a beneficiary to receive benefit on your death, the benefit does not form part of your estate and therefore no estate duty is payable on the benefit. The benefit will transfer directly to your beneficiaries. This coupled with the ability to manage and invest your funds yourself, provide a very attractive pension fund structure.

It is important to note that any withdrawals are deemed taxable at the individuals tax rate, however there are annuity exemptions that apply, and are explained in more detail later in the proposal. Carrick are not tax consultants and therefore recommend speaking to a tax specialist should you have any further queries as to how your withdrawals are taxed.

## Annuities and Moving Abroad

It is important to know that both a Living Annuity and a Life Annuity, cannot be moved out of South Africa once invested. That is to say the investment will remain in South Africa, if you ever decide to emigrate. This includes financial emigration. Important to note though, there is nothing stopping you moving the money you receive from the investments (monthly drawdowns) to wherever you are in the world.

## Cashing in your Retirement Annuities

Retirement Annuities may only be cashed in (and therefore subject to applicable taxes) when an individual financially immigrates. If they do not financially immigrate then that individual may elect to take up to one third of the value of the funds in cash at retirement. The remaining two thirds of the funds must then be used to purchase either a Life or Living Annuity.

## Taxes and Living Annuities

If an individual elects to take a third of his available funds in cash then the first R500,000.00 is deemed non-taxable in the individual’s hands. As such an individual with a pension’s savings pot equal to or less than R1,5m would be free to take up to R500,000.00 from the pot tax free at the time of retiring.

Any pension savings fund pot bigger than R1,5m is therefore subject to a withdrawal tax on a sliding scale, outlined below, if the person elects to withdraw a third of the fund value at retirement. Below is a worked example taken from the SARS website.

| Taxable income from lump sum benefits | Rates of tax |
|---|---|
| 1 – 500 000 | 0% of taxable income |
| 500 001 - 700 000 | 18% of taxable income above 500 000 |
| 700 001 – 1 050 000 | 36 000 + 27% of taxable income above 700 000 |
| 1 050 001 and above | 130 500 + 36% of taxable income above 1 050 000 |

***Example***

X received a lump sum of R682 000 from the ABC Pension Fund, and had received no previous lumps sums prior to this. Over many years, the total contributions which did not previously rank for deduction or qualify for exemption in X's hands amounted to R50 000. Calculate the normal tax payable on this lump sum.

***Result***

The gross lump sum on which normal tax will be calculated amounts to R682 000 less R50 000, which equals R632 000. R632 000 falls within the taxable income bracket of R500 001 to R700 000. The normal tax is therefore 18% of the taxable income above R500 000. Thus:

Normal Tax
= 18% of (R632 000 - R500 000)
= 18% of R132 000
= R23 760

The normal tax on the lump sum of R682 000 therefore amounts to R23 760, and the net lump sum after tax ("cash in pocket") would equal R658 240.

Source Reference: https://www.sars.gov.za/ClientSegments/Individuals/Tax-Stages/Pages/Tax-and-Retirement.aspx

It is important to note that ALL lump sums received from a retirement fund, whether as a result of retirement or not (and from an employer in respect of a severance benefit) are taxed on a cumulative basis. The significant impact of this is that, when the member eventually retires, the total value of all the lump sum benefits received by the member after 1 October 2007, will be taken into account when calculating the tax payable on the member's current retirement fund lump sum benefit. This therefore covers, tax relating to when an individual retires. The next section deals with how tax is levied on annuity income when it is received from a Living Annuity.

Taxes on annuity income such as Living Annuities are taxed at your normal marginal income tax rate, however there are some exemptions. These are outlined.

For the 1 March 2020 to 28 February 2021 year of assessment for the tax season starting during 2021:

- Person below 65 – R83 100 per annum
- Person 65 and above but not yet 75 – R128 650
- Person 75 and above – R143 850.

For the 1 March 2019 to 29 February 2020 year of assessment for the tax season starting during 2020:

- Person below 65 – R79 000 per annum
- Person 65 and above but not yet 75 – R122 300
- Person 75 and above – R136 750.