

How much to commute “tax efficiently” at retirement

Our calculations show that the optimal commutation increases as the retirement benefit and the marginal tax rate increases”

A question that most people grapple with is whether it is more tax efficient to commute a larger lump sum at retirement, especially where all monies must be reinvested to provide an income.

Taxes are levied at three points:

- at commutation
- on investment returns of commuted amounts, and
- on the annuity.

The retirement tax table appears generous and taxes the first R300 000 at nil percent, the next R300 000 at 18%, the following R300 000 at 27% and thereafter a tax rate of 36% applies. The argument for higher commutation is that you have to pay tax at some point, so it is best to pay at a lower rate.

We have chosen a flexible annuity for easy comparison. The part of the benefit that is not commuted, but rather invested in a flexible annuity, continues to earn a tax-free investment return. If a lump sum is commuted and reinvested in a collective investment, the investment return will be subject to Income Tax and Capital Gains Tax.

Finally, when a pension is drawn from the flexible annuity, it is taxed at marginal rates. Amounts withdrawn from the collective investment are tax-free. Below are calculations that determine which combination of taxes is more efficient.

Examples

We considered 3 examples. A retiree with a retirement benefit of:

- Example 1: R2.5m
- Example 2: R5m, and
- Example 3: R10m.

We assume inflation at 5%, an initial drawdown of 7.5% of benefit, growing at inflation, real investment return of 4.5% and where relevant, taxes on the investment return of about 10% of the return. The monetary results for this calculation are sensitive to the above assumptions, but the conclusions should

not change drastically. We chose the total assets at the end of the third year after retirement as the measure to compare different strategies.

Example 1

A benefit of R2.5m will provide a draw-down of R187 500 (7.5%) in the first year, thereby making the most tax efficient scenario to commute only the first R300 000 at nil percent tax. If more is commuted, tax payable on the investment return in the collective investment will exceed the tax payable on the amount commuted.

Example 2

The initial drawdown of 7.5% of a benefit of R5m would come to R375 000 for year one, making the most tax efficient commutation between R600 000 and R900 000 (closer to the latter). The commuted benefit, invested in the collective investment, produces a less tax efficient income than that invested in the flexible annuity. But, the greater an individual’s initial income requirement, the more he/she should commute for tax efficiency.

Example 3

Finally, a benefit of R10m will allow a drawdown of R750 000 (7.5%) in the first year. The most tax efficient commutation here is between R1.8m and R2.1m (nearer to the former), which is again much larger than for the previous examples due to the higher spending in the 3 years under review.

Conclusion

For amounts below R2.5 Million, it is more tax efficient to commute only the tax-free portion of R300 000. For larger amounts, we show that the optimal commutation increases as the retirement benefit increases, even as a proportion of the benefit. This is an important service that funds can secure for their retiring members when they consider and implement a member support tool.

Contact: Willem Le Roux
Tel: +27 21 912 3324
E-mail: willem.lroux@simekaconsult.co.za



Sandton	Durban	Pretoria	Cape Town
4 th Floor, Office Towers Sandton City Cnr Rivonia and Fifth Street Sandton 2196 Tel: +27 11 263 4300 Fax: +27 11 263 4318	1 st Floor, Northwing 2 Cranbrook Crescent Off Douglas Saunders Ave. La Lucia Ridge 4051 Tel: +27 31 566 2302 Fax: +27 31 566 5187	Menlyn Woods Phase 2 Sprite Avenue Faerie Glen 0043 Tel: +27 12 369 8800 Fax: +27 12 369 8830	Simeka House Vineyards Office Estate 99 Jip De Jager Bellville 7530 Tel: +27 21 912 3300 Fax: +27 21 912 3341
www.simekaconsult.co.za		info@simekaconsult.co.za	