Prudential Investment Managers

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Tax-free investments: A closer look at the benefits

ARTICLE SUMMARY

With the 2018/2019 deadline for investing in tax-free unit trusts rapidly approaching on 28 February, we examine the tax-saving benefits inherent to these investor-friendly solutions.

When investing in unit trusts it's important to be aware of the various taxes associated with your investment. Generally speaking, the most common taxes include tax on income and capital gains tax (CGT). The impact of these taxes, however, differs according to your individual circumstances (such as your marginal income tax rate) and the underlying assets that you are invested in, given that different asset classes are subject to different taxes). While it's fairly straight forward that the higher your marginal tax rate the greater the potential tax saving over time, the latter component may be slightly less obvious. So to better understand this, the below highlights the various taxes associated with each asset class, and by implication, where the greatest opportunities for tax savings can be found.

Bonds and cash

If you own bonds or cash in your unit trust, you will incur tax on the interest income they pay out. Cash can include money market funds, bank deposits and any other short-term investments that pay out interest apart from bonds. Your interest income is subject to income tax, and is taxed at your marginal tax rate. Individual taxpayers enjoy a specified annual exemption on all South African interest income they earn, set by SARS every year. For the 2018/2019 tax year this exemption is R23,800 for individuals under 65 years old and R34,500 for individuals 65 years and older.

Equities
For equities (excluding listed property companies), you will incur dividend withholding tax (DWT) on the dividend income they pay out. DWT of 20% is withheld from your dividends before they are paid out or reinvested.

Property
The tax regime associated with listed property companies in the form of Real Estate Investment Trusts (REITs) is more complicated than other asset classes. REITs are taxed differently to other listed companies: they do not pay corporate income tax, and their investors do not incur DWT on the distributions they pay out. Instead, investors pay income tax on the distributions they receive from these REITS at their marginal income tax rate.

CGT is another tax associated with investing in both equities and property. A capital gains eventis triggered only when you decide to sell (part or all of) your investments. If the price of the units has risen since you invested, this increase in value is known as a capital gain (or a capital loss if the value has declined). Currently, for individuals an amount of 40% of this capital gain is included in your annual income; this makes the maximum CGT rate for individuals paying the maximum 45% marginal tax rate 18%. Note that individual taxpayers currently enjoy an annual capital gain exclusion of R40,000. Investors in tax-free unit trusts pay no CGT.

Which tax-free investments offer the most tax benefit?
From the above, it is difficult to determine which types of tax-free assets would offer an individual the most benefit, since it depends on your unique circumstances. However, we can draw the following generalisations:

It is particularly beneficial to hold listed property companies in the form of REITs inside a tax-free investment because there is effectively no corporate or individual tax on the investment returns. So if your primary motivation for investing is to maximise your tax savings, you may want to consider including listed property in your tax-free investment. However, this choice is dependent on many other factors as well, not least whether it is suitable for your overall portfolio.

While it may seem like holding cash inside a tax-free investment is also very attractive, because it does offer relatively high tax savings, it may in fact be the least appropriate asset class to choose for your tax-free investment over the long term. The primary concern of investing in cash (and other short-term assets) is that it earns after-inflation annual returns of 1%-2% over the long term. This is substantially less than the 6%-8% annual real return provided by growth assets like equities and listed property.
Being free of all taxes, the returns on these longer-term investments, re-invested and compounded over many years, will likely be much more powerful than cash. The potential long-term total investment return of cash is low, making it less appropriate as part of a long-term investment strategy.

At Prudential we offer a range of tax-free unit trusts to suit a variety of risk and return requirements. For more information, contact your financial adviser or our Client Services team on 0860 105 775 or at query@prudential.co.za.

https://www.prudential.co.za/insights/articlesreleases/tax-free-investments-a-closer-look-at-the-benefits/