PRUDENTIAL **INSIGHTS**

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Tax-free investments: An attractive option for investors

Have you maximised your R33,000 annual tax-free limit yet? If not, the deadline for your contributions to be included in the 2019/20 tax year is 28 February 2020. The benefits can be considerable over time… read on to find out more.

Tax-free investments were launched in March 2015, and as the name implies, allows investors the opportunity to invest free of tax. Even though the allowed amounts may appear relatively small (with an annual limit of R33,000 and a lifetime limit of R500,000), we consider tax-free investments to be a valuable part of any investor's portfolio, especially when compounded over time.

That said, before investing it's important for you to first carefully consider (and understand) their benefits, and in some cases, their limitations, to determine how best to use them.

What are the benefits?

- All growth in the underlying investment is fully exempt from SA tax on interest, rental income, dividends or capital gains;

- You can withdraw your money at any time (although we encourage our clients to invest for the long term to really benefit from the tax-free nature of the product);
- Contributions are flexible – either via a lump sum or monthly debit orders;
- Tax-free investments are not subject to retirement investment limits; and
- Parents can open separate accounts for their children.

Consider maxing out your RA first when saving for retirement

When deciding whether to invest in a tax-free product or not, one of the considerations that you'll need to take into account is that your contributions to a tax-free investment can only be made from after-income-tax money. This means that if you are planning to use your tax-free investment as your primary savings vehicle for retirement, you actually have less to invest and to grow compared to retirement annuities (RAs), where all contributions qualify for a tax deduction (up to a limit of 27.5% or R350,000 per year of your taxable income), plus growth is exempt from all taxes. This means that, from a maximum return perspective, it would probably be better to first exhaust your RA contribution limit every year before investing in a tax-free savings product.

However, if you are investing for a shorter time, or require more accessibility, RA's do not allow you to access your accumulated savings until age 55, whereas tax-free savings products are accessible at any time. RA's are also subject to retirement investment restrictions (limits to how much you can invest per asset class, etc.) governed by Regulation 28, while tax-free investments are not.

We would suggest that you consult a financial adviser to ensure you make the most efficient decisions for your unique personal circumstances.

Long term is usually better

In order to maximise the advantages of tax-free investments, you should consider investing in longer-term assets like equities and listed property, or diversified funds like balanced unit trusts with relatively high exposure to these assets. This is because, in theory, they are likely to deliver better returns than cash and bonds over time, so the effect of compounding returns will be more powerful than other options.

Of course, these growth assets do come with more risk, so it’s best to stay invested for five to 10 years. This makes tax-free investments more suitable for longer-term goals like your child’s education, a home and as a supplement to your retirement savings. At Prudential you also have access to our range of rand-denominated global funds within the tax-free product, thereby offering more opportunity for you to diversify across asset classes, regions and currencies.

Be aware of the limits

A final consideration is that the government has imposed strict contribution limits of R500,000 per individual over a lifetime and R33,000 per year for tax-free savings products. If you exceed these limits, SARS will levy a penalty of 40% of the excess amount, so it’s important to keep track of your total contributions. And if you withdraw from your tax-free investment, it doesn’t change your lifetime or annual limits. For example, if you invest R33,000 for the tax year and then decide to withdraw it, you won’t be allowed to replace the amount that you’ve withdrawn (i.e. you would have maxed out your contribution limit for that tax year). We would encourage investors to avoid withdrawals if at all possible, because they reduce the compounding growth effect over time.

Don’t forget that the deadline for topping up your tax-free investment for the 2019/20 tax year is 28 February 2020. Prudential offers a range of tax-free unit trusts to suit a variety of risk and return requirements.

For more information and to view our fund range, visit the Tax-Free section of our website. Alternatively, contact your financial adviser or our Client Services team on 0860 105 775 or at query@prudential.co.za.