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Prudential Investment Managers

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Making the most of your tax deductions

With the 2019/20 tax-filing season now underway, many taxpayers are starting to get their paperwork in order with the hope of receiving a tax refund from SARS. While this is largely a "hit or miss" exercise for most people, there are some who deliberately structure their finances to take advantage of the tax benefits that SARS offers. Fortunately, these benefits are there for everyone to use, not just the rich, you really just need a general understanding of what is most applicable to you. While SARS allows individuals to claim a tax deduction against a wide variety of expenses, such as medical and disability expenses as well as donations to certain public benefit organisations, the tax deduction that is arguably the most widely used is their contributions towards an approved retirement fund. In this article, we take a closer look at how this works, as well as certain factors that you may want to consider when deciding how best to allocate your tax refund.

Claiming a tax deduction for retirement fund contributions

SARS allows individuals to contribute up to 27.5% of their remuneration for PAYE purposes or their taxable income (whichever is greater) towards a retirement fund as a tax deduction, up to a maximum of R350,000. When calculating how much tax an individual is required to pay for the tax year, their taxable income is essentially reduced by their retirement fund contributions. SARS then recalculates the amount of tax that they owe (based on the "lower" taxable income amount) and refunds the difference. To demonstrate how this works in practise, let's take a closer look at the example below:

Mr A is under the age of 65. During the 2019/20 year of assessment he earned a gross income of R500,000, of which he contributed 15% (or R75,000) to an approved retirement annuity fund. The below table shows how much tax Mr A was required to pay before and after contributing towards his retirement fund.

	Tax payable before contributing to a retirement fund	**Tax payable after contributing to a retirement fund**
Gross Income	R500,000	R500,000
Less retirement fund contributions	R0	R75,000
Taxable Income	R500,000	R425,000
Tax liability according to the SARS income tax table	R127,875	R100,875
Less primary rebate	R14,220	R14,220
Tax payable	R113,655	R86,655

Based on the above calculation, the amount of tax that Mr A is required to pay is reduced by R27,000, which he can expect to receive back from SARS as a tax refund. This is a substantial amount.

What to do with your tax refund

Supplement your retirement fund contributions: One of the most financially-savvy options for your tax refund is to use it to supplement your retirement fund contributions for the next year of assessment. While there are many advantages of following this approach, there are some drawbacks worth mentioning.

Arguably, the biggest drawback is that retirement investments give you very limited access to your money before retirement. In fact, retirement annuity funds only allow members to access their money before retirement in very specific circumstances (such as in the case of emigration, divorce, or if the value of the investment is below a certain amount). While this may not have been a major consideration in the past, the reality of today's environment is that the economic fallout from the Coronavirus pandemic has forced many investors to tap into their retirement savings (where allowed) to help alleviate some of the financial pressure.

Understandably, withdrawing from your retirement savings has a number of serious long-term consequences and should only be exercised as a last resort. These include: reducing the total amount that you're able to retire with (keeping in mind that withdrawing even a small amount today means missing out on years of compounded growth); and potentially forfeiting a significant amount of your retirement savings to SARS in the form of taxes (due to the heavy taxation on pre-retirement withdrawals). That said, the uncertainty of today's economy has meant that many people now place a greater emphasis on being able to access their money in times of financial difficulty. As a result, using their tax refund to contribute to their retirement fund no longer has the same appeal, in spite of the tax benefits.

Invest in a tax-free investment: The factors highlighted above has meant that some individuals may be considering alternative ways to invest the money they get back from SARS. One approach worth considering is to invest in a tax-free investment. There are a number of advantages of following this route: not only are your investment returns exempt from local taxes, similar to retirement funds, but you also have the flexibility of accessing your money when you need it. A limitation that you'll need to be aware of, however, is that contributions are restricted to a maximum of R36,000 per tax year and R500,000 over the course of your lifetime. Amounts that exceed these limits are taxed at 40%, so it’s important to keep track of your contributions.

At Prudential we offer a range of tax-free unit trusts to cater for a variety of investment objectives. To find out more about our tax-free offering, watch this short video by our Head or Retail Sales, Hamilton van Breda, or visit our website. We also have a Tax-Free Investment Calculator which shows how much tax you could save over the course of your investment by investing in one of our top-performing tax-free unit trusts.

Given that everyone’s financial position is different, we encourage all of our readers to consult a good independent financial adviser when it comes to their retirement and tax planning. For more general information, please feel free to contact our client services team on 0860 105 775 or email us at query@prudential.co.za.