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MoneyTalk

Tax and your Investments

Choosing an effective tax vehicle for your investments will enhance the performance of your investment portfolio, as this example illustrates.

MR T (50 years old) approaches his investment advisor to optimally structure his investment portfolio. He wishes to invest R1 million with the assistance of his investment advisor, but would like some guidance in choosing the advantageous investment structure.

Mr. T earns a substantial salary (R1 200 000) per year.

Table 1 briefly outlines that tax implications of a collective investment scheme portfolio (held in Mr. T's own name), versus the advantages and disadvantages of a portfolio held in an endowment wrapper.

Table 1

Investment Vehicle	Collective Investment Scheme (LISP Platform)	Pure endowment policy (collective investment scheme units as underlying investment)
Tax implications of the investment vehicle during the investment term	Income tax: Net rental and interest income are taxed at the investor's marginal rate. **The Investor can make use of the full interest exemption:** **(R19 000 if below 65 and R27 500 if above 65)** **CGT –Only triggered when units are sold or switched.** 25% (inclusion rate) x marginal tax rate (maximum 40%) = maximum of **10%.** BUT The Investor is entitled to a CGT exemption of **R16 000 per year.**	Income tax: Net rental income and interest taxed at **30%** (Tax payable by the insurer) **Note: no annual interest rate exemption** CGT: Taxed at **7.5%** (25% x 30%). Tax payable by the insurer. **CGT –Only triggered when units are sold or switched.** **Note: no annual CGT exemption**
Tax issues at date of withdrawal from or disposal of the investment	CGT as above, **AS LONG AS NOT TRADING UNITS, OR SELLING THEM SO REGULARLY THAT THEY BECOME AN ANNUITY**	Tax free proceeds at maturity. Again this is useful for the high earner, as he would pay no tax on a big lump sum.

Mr. T also has a formidable pension fund, but no discretionary investments. As Mr. T's personal marginal tax rate is 40%, it would be prudent to channel a substantial portion of his funds to an endowment policy. For liquidity purposes (emergency funds), his advisor also suggests that a portion of his funds be placed in a money market fund, and a certain portion in a collective investment scheme.

Assuming a yield of 12%, Mr. T can invest R158 000 in a money market fund and pay no tax on the interest the investment generates (due to the R19 000 annual exemption). Mr. T also invests R100 000 in a pure equity fund, which will ensure liquidity and hopefully some capital growth. If he sells any of these units at a profit during the tax year, he will be entitled to rely on his R16 000 CGT exemption. The remainder of his funds is invested in an endowment policy. The underlying portfolio of the endowment policy consists of a balanced fund (equity, cash, bonds, and property). The effects of this investment strategy are illustrated in Table 2.

Should Mr. T decide to switch to another equity fund, the switch will trigger Capital Gains Tax if the underlying units in the equity fund have appreciated since he bought into the fund. Assuming that he bought the original units for R1 per unit and the units are valued at R2 per unit when he switches out of the fund, he will therefore make a capital gain of R1 per unit.

Value of fund when switching (selling): R200 000
Base cost of units: R100 000
Capital gain: R100 000
Annual exemption:... (R16 000)
Taxable gain:..R84 000
25% inclusion rate R21 000
CGT at 40% tax rate: R8 400

Had the investment been housed in an endowment policy (ignoring liquidity issues), the switch would have attracted the following tax:

Value of fund when switching (selling): R200 000
Base cost of units: R100 000
Capital gain: R100 000
Annual exemption:..R0
Taxable gain:..R100 000
25% inclusion rate..R25 000
CGT at 30% tax rate (endowment policy) R7 500

The endowment policy would have given Mr. T a tax advantage of R900 in terms of CGT payable in this example, but the net result will vary from taxpayer to taxpayer, and is dependent on the taxpayer's marginal tax rate and the utilization of the taxpayer's annual CGT exemption.

Had Mr. T's marginal tax rate been 30% or below, his CGT liability would have been lower for units held in his own name, and the endowment structure would have therefore been less attractive.

However, a major advantage of using endowment structures is that there is no reporting responsibility for the owner of the endowment, and once the policy matures he is entitled to tax free capital withdrawals from the endowment. The investor also does not run the risk of being classified as a trader if he actively buys and sells underling equity investments within the endowment structure.

If liquidity is not an issue, the higher earning individual with a marginal tax rate of 30% or above will derive greater tax benefit from using an endowment wrapper.

Table 2

Investment	Interest / net rental income or capital growth	Tax position
Money market (R158 000 with a yield of 12%)	Interest (R19 000)	Tax free interest income (yearly exclusion). Any interest exceeding the exclusion will be taxed at 40%.
Tornado pure equity fund (R100 000)	Possible capital growth and minimal interest income.	R16 000 CGT exemption will apply. Any gain exceeding the R16 000 with be taxed at 10% (25% x 40%). Any interest income will be taxed at his marginal rate because he has already used his interest exemption with his money market investment.
Endowment policy – Balanced fund consisting of equities, bonds, property and cash. (R742 000)	Interest, net rental income and capital growth (assuming a portfolio switch to another balanced fund).	Net rental income and interest taxed at 30%. (Payable by insurer) CGT: Taxed at 7.5% (25% x 30%). (Payable by the insurer).

Copied from a TAXtalk article by Martin Swanepoel, a manager at Discovery Life. This publication is subject to our standard Disclaimer to be found at our website www.sjcasa.co.za.

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