The new tax-free savings account: how much will you actually save?

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In our last issue we discussed the National Treasury's plans to introduce a tax-free savings account (TFSA) in March this year; wherein one can contribute up to R 30 000 per year and up to a lifetime contribution of R 500 000. Because the savings invested in a TFSA will not be taxed, it provides a great incentive to save, but where will it fit into your current savings plan and how much will you actually save?

The TFSA amid existing saving opportunities
Investment vehicles available in South Africa can be classified as either retirement savings (pension fund, provident fund, retirement annuity) or discretionary savings (direct JSE investment, unit trusts, property, bank savings).

Saving for retirement is already encouraged as your monthly contribution reduces your taxable income. Also, no tax is paid on dividends or interest during the investment term and if your money is transferred to an annuity at retirement, no tax is charged on it. Withdrawal prior to retirement is, however, discouraged by tax charges. Discretionary investments do not reduce your taxable income and are subject to tax during an investment term as well as at withdrawal.

The TFSA, as depicted in *the table below*, will in contrast not be taxed during or at termination of investment term. As a result, the TFSA can be ideal as a long-term discretionary investment option on top of your existing retirement and discretionary savings.

How much will you actually save?
The extent of the tax saving will vary significantly across the universe of available products since it depends on exposure to interest generating- and dividend-paying instruments, as well as capital gain potential. Dividends received, both locally and offshore, are taxed at 15%, whereas interest earned and a portion of all capital gains realised, are taxed at your marginal personal income tax rate (MR).

Consequently, the extent of the tax saving per product will also vary significantly across investors due to its dependency on marginal tax rates and the difference in tax saving across products will differ significantly at the various marginal tax rates.

Since unit trusts already meet the requirements of a TFSA namely: simplicity, transparency and suitability, we used various products within this space as a base to quantify the potential tax saving.

As per the known investment limits, we modelled a monthly contribution of R 2500 up to the life time limit of R 500 000. We assumed no early withdrawals with full withdrawal only after 20 years. Based on long-term inflation rate, real return[1] per asset class

Composite[1]	Entry: contribution	During: investment term	Exit: withdrawal/termination
Retirement	Deducted from taxable income	Not taxed	Subject to retirement tax
Discretionary	After-tax proceeds	Subject to tax: interest and dividends	Subject to Tax: capital gain
TFSA	After-tax proceeds	Not taxed	Not taxed

[1] *Real return is performance generated adjusted for the impact of inflation*

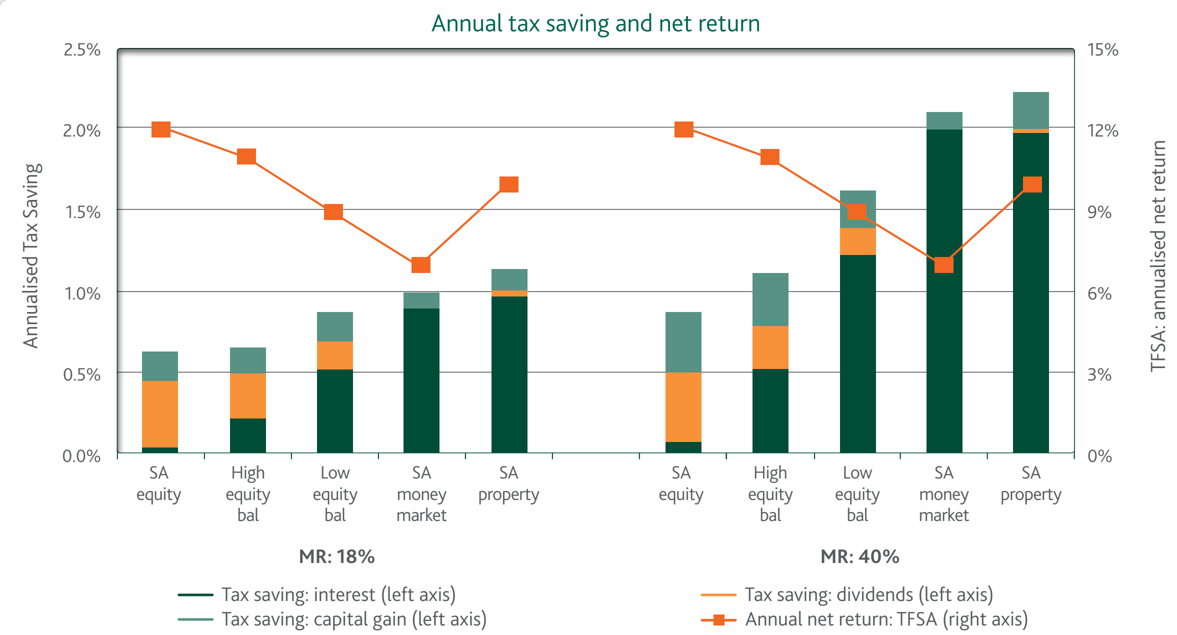
Investment vehicle	Net return pre-tax	Annual tax saving (excl. capital gains tax)		
		MR: 18%	MR: 30%	MR: 40%
SA Money Market	7%	0.90%	1.50%	2.00%
Low Equity Balanced	9%	0.70%	1.10%	1.40%
SA Property	10%	1.00%	1.50%	2.00%
High Equity Balanced	11%	0.50%	0.70%	0.80%
SA Equity	12%	0.50%	0.50%	0.50%

and asset allocation assumptions, we estimated the annual net of fees return per product, as well as the potential tax saving at marginal tax rates of 18%, 30% and 40%.

Equity is expected to be the top performer over the long term, but offers the lowest annual tax saving, regardless of your marginal tax rate, due to the relatively low dividend tax rate. Money market and other interest generating instruments have a lower expected long-term return, but offer a greater annual tax saving than equity instruments. The size of this additional saving greatly depends on your marginal tax rate.

Property, on the other hand, has the unique characteristic of having both a high expected return and annual tax saving, the greatest tax saving regardless of your marginal tax rate in fact. Again, the size of the additional saving offered by property greatly depends on your marginal tax rate. The balanced funds consist of a blend of equity, interest generating and some property instruments, and consequently have an expected return and annual tax saving within the extremes of equity and money market products.

At termination after 20 years, a further saving will be enjoyed due to capital gains realised being tax-free. This saving (*represented by the grey blocks in the table above*) will be the greatest within the equity product, but despite the impact of the additional saving, equity still offers the lowest overall saving and



Source: Nedgroup Investments

Asset class	Expected return	Expected tax saving	Risk level
Equity	High	Low	High
High equity balanced	Moderate - high	Moderate - low	Moderate
Property	Moderate	High	Moderate - high
Low equity balanced	Moderate - low	Moderate	Moderate - low
Money market	Low	Moderate - high	Low

property the greatest. As for interest generating- and property instruments tax saving during investment term, capital gains tax saving is dependent on your marginal tax rate.

The ideal TFSA

The expected return, tax saving per product relevant to your marginal tax rate and suitability relative to your other investments, should be carefully considered in your investment decision-making process to ensure efficient use of the benefit of a TFSA.

We believe the ideal product for tax-free investment is one which offers an expected return and tax saving ranging from moderate to high, as this will allow you to capitalise on the fact that your tax saving will effectively increase your invested assets annually and grow by the power of compounding. SvdM