The impact of tax on investments returns

In my last two newsletters I discussed returns on equities and bonds. Those returns will be affected by tax.

But how?

Lets assume you have R1 million to invest and you don't know whether to put it in a bond (or fixed deposit) yielding 9% p.a, i.e. R90 000.

Your alternative is to buy shares where you expect a dividend income of 3% p.a. (i.e. R30 000) and capital gains of 7% (i.e. R70 000) p.a.

Lets start with the bonds.

If you have no other interest income the first R34 500 will be free of tax (if you are 65 and older) and R55 500 will be taxable and this amount will be added to your other income. If your other income is less than R60 650 and you are over 65 you will pay no tax.

If you are over 75 that figure goes up to R74 350.

The taxable portion of your interest, if your income exceeds those income limits, will be taxed in the range of 18% (the minimum) and 41% (the maximum).

At the minimum the tax will be R9 990 and at the maximum R22 755

At a tax rate of 18% the after tax return is reduced to 8%. At the maximum rate the after tax return is reduced to 6.7%

If you already earn interest in excess of the tax free amount, your return is reduced to 7.2% at a marginal rate of 18% and 5.3% at the top marginal rate.

If the R1 million is split between two taxpayers (say husband and wife and you can negotiate your way through section 7 of the Income Tax Act) and you have no other interest income the taxable amount will only be R10 500 each.

At a marginal tax rate of 18% the return rises to 8.6% and at 41% to 8.14%, an improvement of 1.44% on the 6.7%.

If your bond is housed in a retirement funding investment such as a retirement annuity there will be no tax while it is in the fund.

When you leave the retirement fund tax will be payable on any lump sum taken that exceeds R500 000 and this includes previous lump sums taken. Any income derived from the fund will be taxed as ordinary income.

Lets now look at the alternative, investing the R1 million into shares or an equity unit trust.

The dividend will be R30 000. The tax on that will be R4 500, and it will be withheld at source. The after tax dividend return is therefore R25 500.

If there is a realized capital gain of R70 000, then the first R40 000 is free of capital gains tax and R30 000 of gain is taxable. 40 per cent of that is added to your taxable income i.e. R12 000. The tax on that will depend upon your marginal tax rate. At 18% it would be R2 160 and at 41% R4 920.

At the lower marginal rate you would receive R25 500 in dividends and R67 840 in capital gains, a combined income of R93 340. At the top marginal rate you would receive R90 580. The return would be between 9.3% and 9%.

One may, quite correctly argue that I am not going to realize my investments on an annual basis. Therefore, it is logical to exclude the annual R40 000abatement.

In this case the tax would be R5 040 at a marginal rate of 18% and R11 480 at a marginal rate of 41%.

The after tax return would then be between 9.0% and 8.3%.

As is the case with interest, the dividends and capital gains would not attract tax in a retirement funding instrument. However, tax will be paid once one exits the retirement funding instrument.

What can we learn from this?

It is difficult to give general guidelines.
The impact of tax will vary from individual to individual and from family to family.

It does show, however, that returns can be improved legally by investing in a tax effective way.

Generally, it is better to shelter taxable investments in a retirement instrument, if that is possible.

When investing in fixed interest investments it can be useful to split the investment between husband and wife so that each gets the interest abatement.

I have not discussed tax free investments because the R30 000 maximum annual investment makes it unsuitable for most of our clients.

Finally, experience has taught me that you don't invest just to save tax. In South Africa we had film schemes, plantation schemes, etc. They may have saved tax but they proved to be poor investments.

What is logical, is to develop a sound investment strategy and then to implement it in a tax effective manner.

Kind regards

Brian