Press release
September 2018

VOLUNTARY PURCHASE ANNUITIES (VPAs) – AN UNDERUTILISED BUT TAX-EFFICIENT INVESTMENT CHOICE

When choosing an annuity in retirement it is critical to make sure that the benefit from your savings will outlast your lifetime.

"Take great care when choosing an annuity. It is important that you select the right product that will provide you with the highest possible income. One way to achieve this is through tax efficiency," says Justine Wyatt, Legal and Compliance Executive at Just, a specialised annuity provider.

Purchasing an annuity is often a balancing act that must take into account your age, your gender, your spouse, interest rates and your investment options. You are also not restricted to one type of product in order to generate an income.

For example, there are two types of annuities. A **compulsory purchase annuity** is bought with your retirement savings from a pension, provident or retirement annuity fund. Legally you are required to buy a compulsory annuity with a minimum of two-thirds of the payout from your pension fund or retirement annuity fund savings. By contrast, you can buy a **voluntary purchase annuity (VPA)** at any time with your voluntary or discretionary savings (i.e. savings that you have accumulated separately from your pension, provident or retirement annuity fund). Both types of annuity pay you a guaranteed income.

"VPAs have been around for a long time. However, they have not always been the most popular choice for discretionary savings, with investors largely opting to rather invest in unit trusts. But unit trusts may not always be the most tax-efficient vehicle," argues Wyatt.

Like compulsory annuities, a number of options are available for VPAs. For example, you can choose to receive the same income for a period of time or for the rest of your life or link such income to inflation or a percentage increase of your choice. You can also provide for your spouse or purchase a guarantee so that you can leave a legacy to loved ones after you pass away.

Income from a VPA consists of a capital portion and an interest portion. The capital portion of your income is tax free, but the interest income may be taxable.

"It is our view that a VPA may be a more tax-efficient choice than unit trusts for certain investors' discretionary savings. Investors pay tax only on the interest portion of their VPA income, but on a unit trust investment they may be subject to dividend tax, tax on interest at marginal tax rates and Capital Gains Tax," says Wyatt.

According to Wyatt, tax efficiency is not the only advantage of a VPA. A VPA ensures a guaranteed income, which can be at a higher rate than market returns. VPA income will never reduce but may increase every year by a chosen percentage or a targeted investment return. Unit trusts, on the other hand, are linked to the markets and the value will fluctuate depending on market conditions. A market crash could result in a significant loss of savings, which would be devastating when pensioners do not have the time in the market to bounce back from severe market losses. The less drastic but more likely scenario of sustained poor investment returns could result in the erosion of pensioners' capital, especially if they regularly draw from their investment.

A good example of where a VPA may be the best investment choice is the following: Mrs X sells her house with the intention of moving into a frail care facility for which she must pay a monthly rental. She sells her property for R5 million. If she were to use this amount to purchase a VPA for life from Just (a Just Lifetime Income, or "JuLI"), she would receive a net monthly income of approximately R57 500, with annual increases that target inflation. She may even receive more if she chooses to be medically underwritten and she suffers from ill health or has an unhealthy lifestyle, which may result in a shortened lifespan. In this example, no tax will be paid as the interest portion is below the tax threshold. It is important to note that in looking at the tax applicable to Mrs X's annuity we are assuming that this is Mrs X's only income.

If Mrs X invests R5 million in a unit trust portfolio from which she draws an amount similar to R57 500 per month, the tax outcome favours the VPA. When investing in unit trusts one has a wide range of investment options to choose from: equities, property, bonds and cash. If she invests mainly in equities she will receive dividends, which will be taxed at 20%. If she invests largely in bonds and cash she will be taxed on the interest income at her marginal tax rate. For the purposes of comparison we will assume that Mrs X invested in a balanced portfolio (60% equities and 40% bonds and cash). We also assume a marginal tax rate of 30%. On the basis of these assumptions the investment will attract both dividend and income tax. Capital Gains Tax may also apply when Mrs X withdraws capital monthly to fund her regular expenses.

The above example shows the tax efficiency of the VPA for larger investment amounts.

Wyatt concludes: "For older investors who do not wish to manage their own investments or who understand the risk that one day they may face dementia, the certainty of a guaranteed lifetime income is ideal."

Notes

- Mrs X is 80 years old and is purchasing a with-profit single life annuity.
- For the unit trust investment a dividend yield of 2.5%, income of 5% and capital growth of 5% are assumed.

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