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SECTION 10C:

INCOME TAX STRATEGIES IN RETIREMENT STRUCTURING

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One of the more misunderstood aspects of SA's retirement legislation is what happens when an investor contributes more to a retirement fund than allowed for tax deduction purposes. Many assume that any contribution in excess of the limit is simply money not put to good use. Well, the opposite is true.

Section 10C of the Income Tax Act ensures that these so-called excess or disallowed contributions are retained and eventually deliver real tax relief, often in the form of tax-free annuity income during retirement.

WHERE THE PROBLEM STARTS

Section 11F caps the annual deduction for retirement fund contributions at the lesser of R430 000, 27.5% of the higher of remuneration or taxable income, or taxable income itself. Any contribution above that ceiling is not deductible during that tax year. But rather than being lost, the excess is carried forward in the investor's name and applied later, in a strict order determined by legislation.

That order is also of importance. Excess contributions are carried forward to future years and deducted under Section 11F as your limits allow. If a retirement or withdrawal lump sum is taken, any remaining balance must then be applied against the taxable portion of that lump sum under the Second Schedule, before the retirement tax table is applied.

IN THIS ISSUE

Section 10C of the Income Tax Act provides retirees with a powerful tax-planning strategy, allowing excess retirement contributions to reduce taxable annuity income and potentially enhance long-term retirement outcomes.

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Only thereafter, once the investor is drawing a compulsory annuity, can the remainder be used to exempt annuity income from tax under Section 10C. Importantly, balances are aggregated across all of the investor's retirement funds, and a lump sum always takes priority.

HOW DOES IT WORK?

Section 10C exempts qualifying annuity income, which is income from a compulsory annuity (including a living annuity), from tax until all disallowed contributions have been depleted. In practice this can mean a portion, or even all, of a retirement income stream is received tax-free until the balanced of previously disallowed contributions has been exhausted.

Two practical points are worth flagging up front. First, the exemption provides no upfront relief: the annuity administrator must still deduct PAYE in full, and the benefit is only applied by SARS on assessment, usually as a refund. There are no SARS tax directives for section 10C. Secondly, the exemption belongs only to the member who made the contributions. It cannot be passed to a beneficiary on death, and it does not apply to a pension paid by the GEPF.

A useful practice is to monitor the disallowed contribution balance reflected on the investor's ITA34, and to ensure that the annual contribution certificate is included in their tax return to guarantee the credit is registered correctly.

A SIMPLE EXAMPLE

Take investor John, who retires with R4 000 000 previously disallowed contributions. He withdraws a R2 500 000 lump sum and invests the balance in a living annuity.

The lump sum is dealt with first. The R2 500 000 is reduced by R2 500 000 of the disallowed contributions, leaving a taxable lump sum of R0, where no tax is payable. That leaves R1 500 000 of the disallowed contributions available to offset against future annuity income from the resultant annuity.

In year one, John draws R900 000 of annuity income. The full R900 000 is exempt from tax, leaving R600 000 of the credit intact. In year two, he draws R1 000 000. Only R600 000 is exempt from tax; the remaining R400 000 is taxable, and the credit has now been depleted. Going forward, his annuity income will be taxed normally according to relevant tax tables.

Important to remember: it is the gross annuity income that is offset against the credit, and not the net annuity income.

WHY AND FOR WHOM?

For high-net-worth investors, entrepreneurs who have sold a business, or anyone catching up on years of under-provision, section 10C turns surplus contributions into a stream of tax-efficient income. This is also an excellent strategy, especially for clients/families whose asset base/portfolio is heavily skewed towards discretionary funds and less so towards retirement structures. This creates valuable room for estate planning.

There is also an estate planning dimension worth understanding. A Section 10C tax exemption terminates on the death of the investor. A beneficiary who inherits the annuity does not inherit the benefit of receiving that income tax-free.

However, the estate duty position is separate and more favourable. If the beneficiary elects to continue with the living annuity, any remaining disallowed contribution balance still falls outside the original investor's dutiable estate. It is only when the benefit is paid as a cash lump sum that this balance is drawn back into the deceased's estate under section 3(3)(e) of the Estate Duty Act, with no spousal section 4(q) relief available. In other words, annuitising preserves the estate duty advantage even though the income tax exemption is lost. A distinction that often drives the right advice on death.

Used deliberately, it is a silent, powerful tool. The key is structuring contributions and the eventual drawdown, with the order of application firmly in mind.

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Ruan joined Brenthurst Wealth in 2021 as Wealth Manager in our Stellenbosch office. He obtained his BCom Financial Sciences degree from the University of Pretoria in 2018 and subsequently enrolled with CIMA (Chartered Institute for Management Accountants) as a prospective CGMA candidate. In addition, he completed a Postgraduate Diploma in Investment Management at the University of the Free State in 2021.

Before joining Brenthurst, Ruan gained valuable experience in the tax and advisory field at Crowe Tax and Advisory Services in Stellenbosch.

Ruan is fully qualified to provide advice on all investment matters.

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