Tax free savings account or RA - know the difference

There seems to be some confusion about the difference between a tax free savings account (TFSA) and a retirement annuity (RA). Both interest tax and capital gains tax have annual exemptions which form part of the taxation of discretionary investments, says Carl van der Berg, a financial consultant at Alexander Forbes Financial Planning Consultants.

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"A working individual pays both income tax and tax on any growth. So you pay tax when your discretionary funds (anything outside of a retirement fund structure) grow at a rate that exceeds any exemption in a year of assessment," says Van der Berg,

TFSA is an initiative from government to encourage a culture of saving, and South Africans can now save up to R30,000 a year knowing that the interest, capital gains and dividends they earn are completely tax free.

Money already taxed

"When you contribute to an RA, you are taking money already taxed as income and putting it back into a vehicle you can invest in, and then you pay tax on it when you draw on those funds later. Your contributions are tax deductible against your income in that year of assessment. A TFSA offers greater flexibility for those who are retiring. With an RA, one third of your capital, up to a maximum of R500,000, can be withdrawn tax-free as a cash lump sum at retirement," he explains.

Van der Berg says that for an individual paying a high rate of tax, who also has a high level of discretionary investments, there is a chance that because the growth on the discretionary investments will add additional income to the individual in the current year of assessment, they would run the risk of possibly owing money to the taxman when submitting their tax return.

"Contributions to an RA will help to mitigate this problem as you would be taking already taxed funds and contributing them to an investment where you will be paying income tax on coming out, however these contributions are deductible against taxable income in the current year of assessment."

TFSA allows clients to have 100% access to capital, whereas with an RA, no funds can be accessed until the age of 55. "At this age you are restricted to withdrawing one third of your investment, with the remaining two thirds used to purchase an annuity to receive a monthly income," says Van der Berg.

Asset allocation

With a TFSA you have the right to invest funds however you want. However, with an RA, asset allocation is prescribed to the investor, so this is one of the disadvantages of this type of investment vehicle. In most situations, your RA investment will fall outside the estate as opposed to a TFSA. Funds existing in an RA will fall outside of your estate insofar as they have qualified for tax deductibility. TFSA falls within, meaning you will pay tax at death and nominate a beneficiary via your will.

"RA fees, which include administration, advice and management fees, could be as high as 2.5% of your investment per annum, while a TFSA is probably be less than half of that," says Van der Berg. This means that a TFSA is relatively cheaper than an RA investment.

"If you are considering a TFSA you should shop around to see what fees you would incur. Some platforms offering TFSA have no admin fees and very competitively priced management fees. TFSAs are often cheaper since fund managers are prevented from charging performance fees," he concludes.

Tax payers have until 29 February 2016 to take advantage of these opportunities - the deadline for provisional tax payments.