UCT RETIREMENT FUND

UCTRF RETIREMENT OPTIONS

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UNIVERSITY OF CAPE TOWN

IYUNIVESITHI YASEKAPA • UNIVERSITEIT VAN KAAPSTAD

CONTENT

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This document provides information regarding various options and the implications of these options. The document cannot be regarded as financial advice and members should seek such advice from a FAIS-licensed advisor before deciding on a course of action. The purpose of this note is to provide members of staff with information to enable them to interact appropriately with their financial advisor.

1. OPTIONS AVAILABLE AT RETIREMENT

Members retiring from the UCTRF can take all or part of the retirement benefit as a cash lump sum. Any part that is not taken as a cash lump sum must be taken as an annuity.

Such as an annuity may be in the form of:

- A Living Annuity from the Fund, or
- A Life Annuity or a Living Annuity from an external provider.

The tax and other implications of these options are discussed in this note. In particular, section 5 explains the primary features of Life and Living Annuities. It is important to understand the difference clearly in order to make an informed decision at retirement in terms of which type of annuity is best for you.

Recent legislation provides for postponement of the payment of the benefit/accrual by 'Phased Retirees'. From 1 March 2015 the member may elect when to retire from the fund (i.e. it is no longer tied to the date of actual retirement from the employer).

Thus the retirement benefit accrues only when election is made regarding the payment of the benefit rather than on the date of retirement from the employer, as it did previously. Retirement from the Fund still requires two full calendar months' notice and in the event of death after the date of retirement from the employer but before retirement from the Fund, the provisions of Section 37C of the Pension Funds Act would be applied.

2. TAX IMPLICATIONS OF THE OPTIONS

2.1 What if I take a lump sum? Will I pay tax?

An amount of up to R500 000 received by way of lump sums, covering any bonus or leave gratuity, etc. is free of tax, to the extent that the R500 000 has not yet been utilised (e.g. at a previous retrenchment). Legislation allows for lump sum amounts paid on retrenchment to be taxed according to the same table as used for retirement benefits. As these amounts from the employer (UCT) and from the Fund (UCTRF) will be aggregated, the exemption to be enjoyed will be R500 000 over your lifetime in respect of all such lump sums received. When you retire, you will not pay tax on the original amount of your AIPF Transfer Value (if applicable), assuming that you take this amount as part of a lump sum benefit from the UCTRF. You will only pay tax on its investment growth.

In addition, when you retire, you will pay tax on the aggregate of this retirement fund lump sum benefit and any retirement fund (or other) lump sum withdrawal benefits received by or accrued to you prior to this event (as explained in section 2.1 above), as follows:

a. Aggregate benefit not exceeding R500 000 – 0%;
b. Exceeding R500 000 but not exceeding R700 000 – R0 plus 18% of amount exceeding R500 000;
c. Exceeding R700 000 but not exceeding R1 050 000 – R36 000 plus 27% of amount exceeding R700 000;
d. Exceeding R1 050 000 – R130 500 plus 36% of amount exceeding R1 050 000.

Example: Calculation of tax-free lump sum

Member elects to take R750 000 lump sum from his/her UCTRF retirement benefit (assuming this is the only lump sum to be received by the member):

AIPF transfer value (as applicable): R 125 200
(This R125 200 will be tax free)

The remaining R624 800 (R750 000 less R125 200) will be taxed as follows:

R500 000 at 0%	*R 0*
R124 800 at 18%	*R 22 464*
Total tax	*R 22 464*

In this case the retiring staff member will receive a cash lump sum of R727 536 after tax (R750 000 – R22 464), provided she or he has not "used up" any of the tax free allowances in respect of any other retirement fund withdrawals from other funds or other employers. (This includes any payouts from preservation funds or retirement annuities you might have.)

2.2 Leave pay

Any untaken study leave (including research leave for academic staff) will be paid out to you in the second week after your last day of service. If any you have leave pay is due to you on retirement, any monies owing to the University on your retirement will be deducted from your leave pay. Any leave pay due to you may form part of the tax-free amount that SARS allows to be paid out on retirement. Please email the HR Retirement Officer on rowina.nefdt@uct.ac.za to apply for the tax directive for the leave payment, in order to have this paid out tax free as part of the tax-free value.

2.3 What if I choose a monthly pension? Will I pay tax?

If you choose to take a monthly pension, no tax is payable on the value utilised to purchase the pension. Tax will, however, be deducted from the monthly pension you receive at the applicable tax rates for that tax year (as if you were earning a salary). There are exceptions to this, where you use part or all of a lump sum retirement benefit amount (after any tax payable) to purchase what is known as a voluntary purchase annuity, where a portion of the pension is tax-free income in your hands.

2.4 Voluntary purchase annuities

A cash lump sum received by a retiring member (**after** the deduction of tax in terms of the Second Schedule of the Income Tax Act) can also be used to purchase an annuity.

Such an annuity is regarded for tax purposes as a "voluntary purchase annuity" and only the interest portion of the monthly annuity payment (rather than the entire annuity) is taxable in the member's hands. (SARS have a formula for determining the interest portion.)

If you do not need to take as much as is permitted tax free in the form of cash at retirement, it will be worthwhile for you to consider securing a voluntary purchase annuity with the difference between the maximum tax-free amount and the lesser amount of cash you wish to take.

3. HOW MUCH SHOULD I TAKE AS A LUMP SUM?

In deciding how much cash to take, you should consider inter alia the following, as well as any other personal circumstances:

a. Any debts that should be repaid (e.g. house bond);
b. Your tax position;
c. Future accommodation plans, particularly in the event of old age and the need for frail care;
d. Your marital status and/or the need to provide for other financial dependants;
e. Your state of health (and that of any financial dependants you may have) and future medical costs;
f. Any current and future anticipated cash needs that require funding (e.g. overseas trip, replacement of car, children's education, purchase of property);
g. Any other investments you have, outside the Fund;
h. Other sources of income (e.g. maintenance payments, retirement occupation, leave pay, other investment income);

i. Any life assurance policies that would make provision for dependants in the event of your death after retirement; and
j. Importantly, the reduction in future income (pension) that will result from taking part of your benefit in the form of cash.

A suitably qualified financial advisor will be able to help you decide how much to take in cash and how much to take in the form of an annuity.

4. INVESTMENT OF THE LUMP SUM

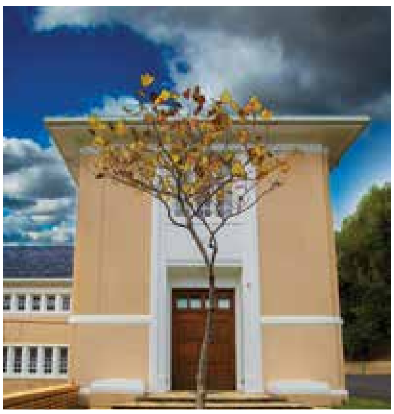
In general, you should not take more of your retirement benefit in the form of cash than you need to, thus leaving as much as possible to secure an income that will last the rest of your life. You may however wish to take some cash to hold as a source of liquid cash when unexpected expenses rise. The most appropriate vehicle for the investment of such a cash lump sum will generally depend on the likely time horizon before cash is required.

Clearly if the time horizon is long (5 – 10 years) then exposure to asset classes that are more risky but have a higher expected return (e.g. equities) could be considered. On the other hand, if the time horizon is short (e.g. less than say 1 – 2 years), then fixed deposits, money market and other near-cash instruments should be considered.

The choice of vehicle to use for such investments is complex (e.g. unit trusts, now more correctly termed Collective Investment Schemes, or endowment insurance policies) and financial advice from a FAIS-licensed advisor should be obtained in this regard.

Under an endowment policy, while the proceeds of the policy are paid to the policyholder free of tax, the investment income earned in the policy before maturity is subject to tax in the hands of the life insurance company.

There is also a five-year minimum term for an endowment policy. If the money is invested in a Collective Investment Scheme (unit trust), including a Money Market fund, the interest income and capital gains arising from such investments will all be taxable in your hands.



5. TYPE OF ANNUITY

You may choose between different types of annuity. The main types are summarised below:

5.1 Life Annuity

Under a **Life Annuity,** the insurer assumes the risks/opportunities of investment and also the risk that the annuitant (the pensioner receiving the annuity payments) lives for longer than expected.

A Life Annuity can be level or can be structured to provide for annual increases. It can also provide for a spouse's annuity and/or the continuation of the annuity for the balance of a specified period (e.g. 5 years) on the death of the annuitant. If no such provision is made, the Life Annuity will cease on the death of the annuitant.

The annuity instalments are fixed under a level annuity and cannot be reduced by the insurer – alternatively, they can escalate each year at a fixed rate (e.g. 5% or 6%), or a variable rate, (see the discussion of with-profit annuities in section 5.4) or in line with inflation. For a given capital amount, the higher the rate of increase built into the annuity, the lower the starting level of the annuity.

5.2 Living Annuity

Under a **Living Annuity** the annuitant decides how the capital is to be invested, and must also choose each year a pension level of between 2.5% p.a. and 17.5% p.a. (or such limits as determined by SARS) of the Living Annuity account balance. The annuitant must manage the investment of the capital and the draw-down percentage to ensure an adequate annuity for life. The annuitant takes on the full investment risk and also the risk of living too long (so that the money is depleted to a level where it cannot provide the necessary income before you die). This is a key risk associated with Living Annuities, which is often not given sufficient weight by retirees making the choice of annuity type; you should be very conscious of the long-term risk of dwindling capital leading to reducing income before committing to a Living Annuity.

On the death of the annuitant, the Trustees or the external provider, as applicable, will allocate any remaining capital to the annuitant's dependants.

The key features of Living Annuities are provided on the UCTRF website at the following link: http://www.uctrf.co.za/92/P/Living-Annuitants

5.3 Choice of annuity

The choice of a life or Living Annuity generally revolves around:

- The extent to which the annuitant requires the annuity to meet basic living needs (in real terms). If the annuitant has no other income beyond the annuity, then a Living Annuity may not be best. Similarly, if the annuitant needs a high draw-down percentage income (in excess of 5% or 6% p.a.) in order to meet her or his needs, this again may mean that a Living Annuity is not the best choice, because it increases the risk that the capital invested will be depleted before he or she dies.

- If the member is in poor health, and is not expected to live very long, then a Living Annuity may be appropriate, given that the remaining capital balance would pass to any remaining dependants in the event of an early death. (This only applies to a small minority of retirees, and one can achieve a similar outcome by investing in a Life Annuity with a long guarantee term.)

- The retiring member's views on security/risk, inheritability, and her or his investment expertise, should also be considered.

You can terminate a Living Annuity and use the proceeds to purchase a Life Annuity at any time (subject to the insurers being willing to provide Life Annuity quotations), but once you have purchased a Life Annuity you cannot vary the contract – it is a lifetime commitment. (Note that if you terminate a Living Annuity, your only option is to purchase another annuity to replace it – you cannot take a cash payment.)*

**See section on Multiple annuities.*

5.4 Life Annuities from an insurer

There are a number of different options available in respect of Life Annuities from insurers. The key decision areas are as follows:

- **Guaranteed period for the payment of the annuity** – Life Annuities can be purchased with no guaranteed period, or a specified guaranteed period.

  Where no guaranteed period is chosen, the annuity ceases immediately on death of the annuitant.

  Where a non-zero guaranteed period is chosen (e.g. 5 or 10 years) then, on death of the annuitant before the expiry of the guaranteed period, the full amount of the annuity (together with any increases the Insurer grants thereon) will continue to be paid for the balance of the guaranteed period.

  The longer the guaranteed period selected, the lower the starting level of the pension (for a given amount of capital available to buy the annuity).

- **Annuity on death to the surviving spouse** – the annuity can make provision for a pension to continue to a surviving spouse or life partner after the death of the annuitant. The initial pension will be lower (for a given amount of capital available to buy the annuity) if a spouse's pension is allowed for. The spouse's pension will usually be expressed as a percentage (e.g. 75%) of the original pension, because your spouse's income needs may be lower after your death. In the event of an annuitant's death before the expiry of the guaranteed period, the full annuity will be payable for the balance of the guaranteed period before reducing.

- **Future annuity increases –** the annuity can be level or provide for annual pension increases. An annuity that provides annual increases will initially be lower than an annuity that remains level (for a given amount of capital available to buy the annuity).

  Purchasers of annuities should consider the impact of future inflation on fixed incomes and avoid the temptation of going for the higher initial pension that does not provide for future increases (as they then take on significant inflation risk).

  There are three broad classes of annuity that provide increases: the **Fixed Escalation Annuity**, the **Inflation-Linked Annuity** and the **With-Profit Annuity.**

  Under all three of these annuity types, the annuitant can select the extent of the provision to be made for future increases. The higher the allowance for future increases, the lower the starting pension (for a given amount of capital available to buy the annuity).

  a. **Fixed Escalation Annuity –** the annual increase percentage is chosen at outset and remains fixed each year, e.g. an increase in the annuity of 5% per annum.

     This annuity type provides certainty about the level of future increase. However, if inflation is high the chosen escalation may be inadequate.

     The price of guaranteed escalation annuities depends heavily on the current level of long-term interest rates (i.e. the prices of long-term Government bonds) at the time of buying the annuity.

  b. **Inflation-Linked Annuity –** the annual increase percentage is linked to the rate of inflation as measured by performance in the Consumer Price (CPI). Inflation-linked annuities tend to be the most expensive option, in the sense of offering the lowest initial pension, but they offer the greatest peace of mind in terms of inflation protection.

  c. **With-Profit Annuity –** increases emerge in the form of the bonuses declared annually by the insurer. The bonus varies annually depending largely on the investment and mortality profits or losses made by the insurer on the with-profit annuity portfolio.

  The annuity is calculated based on a low future interest rate (e.g. 3%) that is chosen by the annuitant at the outset. The difference between this budgeted return (e.g. 3% p.a.) and the investment returns actually achieved by the insurer, suitably smoothed at the

Insurer's discretion and after allowing for insurer costs (see below), is declared by the insurer as an annual annuity increase. (What this means is that, if the investments held by the insurer to provide for the pension payments achieve a return of 3% per year or less, after all expenses and charges, then the insurer will not be able to grant any pension increases. If the net returns are higher than 3% p.a., on average over time, the insurer will grant increases.) The insurer smoothes the investment returns and pension increases after allowing for expenses, and capital and shareholder charges. The bonus, once declared, cannot be taken away.

The lower the interest rate chosen by the annuitant initially, the lower the starting level of the pension (for a given amount of capital available to buy the annuity), and the higher the expected future increases. Historically, annuities based on an interest rate of around 3–4% p.a. have produced increases that, over time, have largely kept pace with inflation.

A with-profit annuity gives a reasonable hedge against inflation since if inflation increases, so should investment returns. However, there is no guarantee of this in future and if investment returns are poor in any given year, the with-profit annuity may provide no or low increases (e.g. both Old Mutual and Sanlam gave very low, or zero, increases in 1999).

HISTORY OF ANNUITY INCREASES GRANTED IN JANUARY EACH YEAR:

Increase month	Interest rate at which pension is purchased		Inflation previous 12 months
	4 %		
	Old Mutual	Sanlam	
January 2000	6.8%	2.4%	2.2%
January 2001	10.4%	8.7%	7.0%
January 2002	7.4%	6.0%	4.5%
January 2003	6.4%	5.5%	12.4%
January 2004	2.4%	1.0%	0.4%
January 2005	5.4%	2.5%	3.3%
January 2006	8.4%	4.0%	3.6%
January 2007	11.4%	4.0%	5.8%
January 2008	11.4%	6.3%	9.0%
January 2009	6.4%	6.0%	9.5%
January 2010	4.4%	3.5%	6.3%
January 2011	4.9%	5.3%	3.5%
January 2012	4.4%	6.3%	6.1%
January 2013	5.9%	5.3%	5.7%
January 2014	9.4%	6.4%	5.4%
January 2015	10.4%	7.7%	5.3%
Last 5 years average	7.0% p.a.	6.2% p.a.	5.2% p.a.
Last 10 years average	7.7% p.a.	5.5% p.a.	6.0% p.a.

Notes:

1. *The purpose of the table is to show the long-term history of pension increases granted by two insurers, Old Mutual and Sanlam, on their long-standing with-profit annuity pools.*
2. *While these long-standing with-profit annuity pools continue for existing participants, they were closed to new retirees in 2002 (Old Mutual Optiplus) and 2001 (Sanlam Bonus Pensions). Thereafter the insurers opened new with-profit annuity pools subject to different increases that are not shown above.*
3. *The fact that the pension increase history of Old Mutual and Sanlam is shown above is NOT an endorsement of these two providers; these two providers are shown because they have the longest track record.*
4. *The inflation referred to is "headline" inflation or CPI, the commonly published figure. The figures shown are the change in headline inflation for the 12 months ending in December of the previous year (i.e. for the January 2015 increases shown, the inflation figure is for the year to December 2014).*

- **Composite Life and Living Annuity** – some insurers offer a composite life and living annuity, with the Life Annuity providing basic security.

5.5 Amount of Life Annuity for a given capital

The annuity that can be secured from an insurer by a given capital will depend on the age and sex of the annuitant and the choice of the above factors. Quotations must be obtained through a financial advisor or through the UCTRF at the time of retirement.

Insurers do not disclose the various costs that they build into their insured annuities. However, except for the commission (which must be disclosed to you), you do not pay the costs directly – the insurer takes them into account at the outset when setting the amount of the annuity that you will receive, per Rand invested in the product.

5.6 Living Annuity from external provider

You can choose to receive a Living Annuity from an insurer of between 2.5% and 17.5% per annum of your capital used to purchase this pension.

Every year on your annuity anniversary date you will have the option to decide what percentage of your capital your annual pension will be. It is suggested that you speak to a financial advisor to help you decide on this percentage as your pension must last you for the rest of your life. Drawing an income of more than 5 – 6% of the invested capital, especially in the early years after your retirement, is probably unwise – you should certainly discuss this with a financial advisor.

Insurers offer various investment portfolios for living annuitants.

5.7 Living Annuity from UCTRF

As with an external provider, your Living Annuity must be at least 2.5% per annum of your capital.

At the same date the UCTRF actuary will calculate the maximum percentage annuity (pension) you may take so that your retirement savings plus investment returns should last your expected lifetime. This will be lower than the legal 17.5% maximum. You may, but should not, choose to withdraw more than this maximum percentage, but the Fund will then require that you indemnify the Trustees and certify that you have taken this decision after taking appropriate financial advice.

In addition to this maximum percentage, the Fund will provide a *recommended maximum percentage*. As you would expect, the Trustees recommend that you attempt to keep your drawdown rate at a lower level than this, if at all possible.

For example, the maximum percentage set by the actuary might be (say) 11%. If you want to draw more than this percentage, you will have to provide the Fund with an indemnity and also certify that you have taken appropriate financial advice on this decision. *The recommended maximum percentage* provided by the actuary might be only 6%. In this case, the Trustees thinks it would be wise for you to restrict your drawdown rate to not more than 6% - however, if you wish to draw up to 11% (in this example) you may do so, without providing an indemnity or taking financial advice. Whatever your drawdown rate, you must understand that it is at your own risk – the Fund and UCT cannot bail you out if you draw down at too high a rate (and/or if your investments in the Fund perform poorly) so that your capital is seriously depleted before you and your spouse both die.

It is advisable that you speak to a financial advisor to help you decide on this percentage as your pension should last you for the rest of your life.

The UCTRF currently offers living annuitants the choice of Portfolios A, B, C and D (respectively the Income Fund, Smooth Bonus Fund, Balanced Fund and Shari'ah Fund). Switching between portfolios is allowed subject to the conditions laid down by the Trustees.

5.8 Living Annuity cost comparison (Insurers vs UCTRF)

Living Annuities from insurers are generally more costly than from UCTRF, as shown in the following comparison (table based on a capital amount of R1 million). The insurer charges are highly variable from company to company, but the figures in the table below are broadly indicative indicative of the level of charges levied by insurers:

Cost item	Indicative insurer's cost		UCTRF	
	Cost basis (excl. VAT)	Year 1 cost (excl. VAT)	Cost basis (excl. VAT)	Year 1 cost (excl. VAT)
Annuity payment fee	0.30% of assets – may be on a sliding scale. This fee may be subsidized from the investment fees (i.e. you may not pay it directly)	R3 000 p.a. (but you may not pay this directly)	R418 initial management fee R10.48 per month	R418 R125.76 p.a.
Annuity administration fee			R26.32 per month	R315.84 p.a.
Investment fees	0.5% to 1.5% p.a. of market value of assets (depends on portfolio chosen by member)	R5 000 p.a. to R15 000 p.a. depending on investment choice	0.2% to 0.9% p.a. of market value of assets (depends on portfolio chosen by member)	R2 000 p.a. to R9 000 p.a. depending on investment choice
Switching fees	Insurers now commonly allow free switching		R404 per switch	Only applicable to October switch
Advisor's fees	Negotiable up to 1% p.a., but insurers may also accept "direct clients" where no advisor is involved	Negotiable up to R10 000 p.a. (if payable)	Not applicable	Not applicable

5.9 Multiple annuities

Multiple annuities can be purchased (for example from different insurers). SARS no longer prescribes minimum annuity amounts for each annuity, should a retiree purchase multiple annuities. You should bear in mind however that it can be very expensive to purchase small annuities.

5.10 Life Annuities vs Living Annuities

A Living Annuity, for example, might be suitable for a retiree who expects to continue earning for, say, 5 years after retirement and thus "parks" his/her retirement capital for 5 years and buys a Life Annuity 5 years later (taking advantage of the fact that rates for a 70-year-old will be cheaper than rates for a 65-year-old; other things – especially interest rates – being equal). Alternatively, such a member could become a 'Phased Retiree', delaying retirement from the Fund until a later date when other earnings fall away.

The questions you should ask yourself are as follows:

- How much income do you want in retirement?
- How much income do you need in retirement?
- How much can you afford with your retirement savings?
- Do you have other sources of income?
- Do you have the relevant financial knowledge to make the correct decisions when choosing your portfolios?
- What will happen to the pension income over time, taking into account the future inflation? Or put simply, how much would you be able to afford to buy with your pension 20 years from now?
- Can you sacrifice a portion of the income now, to enjoy relatively higher income later in retirement?
- What impact will different investment strategies have on your pension in the future?
- What is the risk of outliving your retirement savings?

You will almost certainly find that professional financial advice is useful, if not essential, in making the choice of post-retirement strategy.

6. CONTACT DETAILS

For any queries or comments please contact:

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