Sinking Funds Demystified

In the ever-evolving landscape of personal finance and wealth management, investors are faced with an increasingly wide array of choices. In South Africa, the investment universe has many options, from unit trusts and share portfolios to retirement annuities and tax-free investment accounts. Each type of investment comes with its own set of advantages and limitations, and their effectiveness often depends on the investor's goals, time horizon, and tax considerations. Navigating this landscape requires not only a clear understanding of each investment product but also a strategic approach to combining them in ways that support long-term wealth creation.

One of the investment choices is a **sinking fund**, sometimes referred to as a tax-efficient fund or a life policy wrapper. It's a product that has often been misunderstood due to its seemingly complex structure and long-term nature. Many investors overlook them because of rigid terms, limited liquidity, and layered fees, and sometimes confuse them with an endowment, as they are similar.

Sinking funds offer a unique combination of **tax efficiency**, **estate planning benefits**, and **structured liquidity for long-term investing**. When used appropriately, especially for goals like legacy planning or funding future liabilities, they can be a powerful tool in a diversified wealth strategy, especially for high-net-worth individuals and trusts. This article aims to unpack the key features, limitations, and strategic uses of sinking fund policies in South Africa.

What is a Sinking Fund?

A sinking fund is a **life insurance-based investment product** that is governed by the Long-Term Insurance Act. Even though it's a life policy, sinking funds no longer resemble traditional life insurance products (picturing a man with a briefcase trying to sell you a product!). Besides some restrictions, it's now very similar in look and feel to a unit trust investment, both in the range of the funds available and its wide accessibility across investment platforms like Allan Gray, Glacier, and Ninety One.

Investors can contribute either a lump sum or recurring premiums into a local or offshore portfolio of unit trusts or other instruments, with one or more nominated beneficiaries, where the policy matures after a minimum term of five years. While sinking funds are subject to certain rules and restrictions, they are considered discretionary investments and are not bound by Regulation 28 of the Pension Funds Act.

The Case for Sinking Funds

1. Tax Efficiency

Sinking funds can be used as tax-efficient vehicles for high-income earners. Unlike other discretionary investments, where returns are taxed at the investor's marginal rate, sinking funds are taxed within the policy at a flat rate of 30%. This can result in significant tax savings for individuals in higher tax brackets.

Trusts with natural beneficiaries can also take advantage of the flat tax rate of 30% compared to their standard flat rate of 45%. Sinking funds do not offer tax advantages for companies. Companies already pay tax at a flat rate of 27%, so the internal tax structure of a sinking fund offers no benefit. Companies cannot nominate natural person beneficiaries, limiting estate planning benefits.

When you invest in a sinking fund, the life insurance company is the legal owner of the investment. Because of this, the insurer pays the tax on any income or capital gains earned inside the sinking fund on your behalf.

Why This Matters for Individual Investors

- Your investment is placed in the **Individual Policyholder Fund**.
- The insurer pays 30% tax on interest earned from the investment and 12% net effective CGT on your behalf.
- You don't need to declare this income or gains on your personal tax return.
- You won't get the R40,000 annual capital gain exclusion or annual interest exemption that you would with a direct investment, so these exemptions remain intact, which can be utilised for other investments.

This structure is especially useful if your personal marginal tax rate is higher than 30%, as it can reduce your overall tax burden.

Example

Let's say you're in the 45% tax bracket and you earn R100,000 in interest from your investment:

- In a direct investment, you'd pay R45,000 in tax.
- In a sinking fund, the insurer pays R30,000 in tax on your behalf.
- This results in a R15,000 tax saving, with no need to file anything with SARS.

2. Estate Planning Benefits

A sinking fund will continue into perpetuity until the investment is fully withdrawn or the individual investor dies without a nominated beneficiary. From an estate planning perspective, sinking funds allow for the nomination of beneficiaries, which enables the insurer to transfer the policy or pay out benefits directly to them. This avoids executor's fees and ensures faster access to inherited assets, often within weeks. Capital gains tax rolls over and is therefore not triggered when the policy is transferred into the name of your beneficiary/ies after you pass away.

How Endowments Differ from Sinking Funds

- Unlike endowments, which may terminate prematurely upon the passing of the life assured, sinking funds offer greater continuity and control.
- Sinking funds do not enjoy creditor protection under Section 63 of the Long-Term Insurance Act, which is available to endowments where the policyholder or their spouse is the life assured.

3. Liquidity Considerations

Sinking funds enforce a minimum five-year restricted term, promoting disciplined investing and long-term financial planning. While this limits short-term access, it encourages investors to stay focused on their financial goals while allowing the investment to benefit from compounding growth.

During the initial five-year period, investors may make one withdrawal without repayment, and in some cases may be allowed one interest-free loan, ensuring that funds are not entirely inaccessible. Any withdrawal is limited to the amount of total contributions plus interest at a rate of 5% p.a. However, any withdrawals or surrenders beyond these allowances may incur penalty costs.

To enhance liquidity, investors can open multiple sinking fund policies, which is platform-dependent. Once the five-year restriction ends, withdrawals are unrestricted in both frequency and amount, and all other benefits remain intact. Additional contributions, within legislated limits, can be made without restarting the restricted term. A new 5-year restriction period begins if your annual contributions are 20% or more above the highest annual contribution in the previous two years.

Here is a table that shows a comparison across some of the common investment vehicles in South Africa:

Year	Sinking Fund	Retirement Annuity	Standard Unit Trust	Tax-Free Investment
Tax Efficiency	Taxed internally at fixed rates (30% income, 12% CGT)	Contributions are tax-deductible (within limits, see below); growth is tax-free until retirement	Taxed at an investor's marginal rate; CGT and income tax apply directly	No tax on interest, dividends, or capital gains
Liquidity	Limited liquidity during the initial 5-year term; one withdrawal or loan may be allowed	Cannot withdraw until age 55; limited early access	Highly liquid; can be accessed at any time	Highly liquid; can be accessed at any time
Contribution Limits	Minimum investment thresholds apply, but no limit on the initial first year of contributions, and thereafter the 120% rule applies.	No contribution limits, however annual limit of 27.5% of taxable income or R350,000 (whichever is lower) to get the tax deduction.	No contribution limits, but minimum investment thresholds apply.	Annual limit of R36,000; lifetime limit of R500,000
Estate Planning	Proceeds go straight to beneficiaries; avoids executor fees	Not part of estate, pays direct to beneficiaries or dependents; subject to retirement fund rules/trustees' decision.	Forms part of the estate; subject to executor fees unless held in trust	TFSAs linked to life insurance companies can bypass your estate and pay directly to beneficiaries, while standard TFSAs typically form part of your estate.
Accessibility	Accessible via life companies and platforms	Accessible via fund management companies and platforms.	Widely accessible via fund management companies and platforms.	Accessible via fund management companies, platforms and banks

Common Questions About Sinking Funds

Here are the answers to some common queries about sinking funds:

Question	Answer
How is tax calculated in a sinking fund?	Internally by the insurer using the five-fund approach.
What is the benefit of sinking funds with estate planning?	If you have nominated beneficiaries, no executor fees are paid, and the transfer to a beneficiary is quick. No estate duty is payable if the spouse is the beneficiary.
Are sinking funds suitable for trusts or companies?	Trusts - yes, the key tax advantage is if beneficiaries are natural persons; Companies – they can be used, but there are no further tax advantages.
Can I nominate multiple beneficiaries?	Yes, you can.
What are the liquidity restrictions?	One withdrawal (and sometimes an interest-free loan) is allowed in the first five years.
Is a sinking fund better than a unit trust?	Depends on your tax rate, estate planning needs, and liquidity preferences.
Are sinking funds protected from creditors?	No, this is one of the main differences to an endowment.

Sinking Funds are Not One-Size-Fits-All

Sinking funds may not be suitable for every investor because they come with specific constraints that limit flexibility. The fixed terms and restricted access to funds can be problematic for those who may need liquidity or want to adjust their strategy over time. Additionally, the tax advantages of sinking funds may not benefit individuals in lower tax brackets.

But for investors in higher tax brackets, those with estate planning needs, or those seeking structured long-term growth, sinking funds can be a highly effective financial planning tool. The key is understanding the tax mechanics, liquidity constraints, and how to structure the policy to maximise its benefits.

MARKET REPORT

30/09/2025

		3m	YTD	1yr	3yr pa	5yr pa	10yr pa	5yr Vol1	10yr Vol1
LOCAL MARKET INDICES									
SA Equity	ZAR	12.6%	31.0%	27.9%	22.5%	18.3%	10.8%	13.7%	14.3%
SA Listed Property	ZAR	6.5%	11.9%	10.9%	23.2%	21.1%	2.6%	18.8%	21.4%
SA Bonds	ZAR	6.8%	13.5%	13.9%	15.1%	11.4%	9.2%	7.2%	8.1%
SA Cash	ZAR	1.8%	5.7%	7.8%	8.0%	6.4%	6.8%	0.5%	0.4%
Balanced Benchmark	ZAR	8.4%	19.8%	20.1%	19.1%	14.9%	10.2%	9.4%	9.8%
SA Inflation (1 month lag)	ZAR	1.1%	3.3%	3.4%	4.2%	5.0%	4.8%	1.6%	1.7%
GLOBAL MARKET INDICES BASED TO USD									
Global Equity	USD	7.3%	17.2%	17.3%	23.8%	14.5%	12.6%	15.4%	15.0%
Emerging Markets Equity	USD	11.0%	27.4%	17.5%	18.0%	7.0%	7.7%	16.3%	16.8%
Global Property	USD	4.0%	11.0%	-0.4%	9.3%	5.5%	3.7%	18.2%	17.0%
Global Bonds	USD	0.6%	7.9%	2.3%	5.3%	-1.6%	1.1%	7.8%	6.5%
US Cash	USD	1.1%	3.3%	4.6%	4.9%	3.1%	2.2%	0.7%	0.6%
MAJOR INDICES BASED TO RANDS									
SA Equity	ZAR	12.6%	31.0%	27.9%	22.5%	18.3%	10.8%	13.7%	14.3%
Global Equity	ZAR	4.2%	7.7%	17.5%	22.2%	15.3%	15.1%	14.7%	15.8%
Emerging Markets Equity	ZAR	7.8%	16.5%	18.5%	16.4%	7.3%	10.2%	12.6%	13.6%
Global Property	ZAR	1.0%	2.0%	-0.2%	7.8%	6.2%	6.0%	16.6%	17.1%
SA Bonds	ZAR	6.8%	13.5%	13.9%	15.1%	11.4%	9.2%	7.2%	8.1%
Global Bonds	ZAR	-2.3%	-1.4%	2.5%	3.9%	-1.0%	3.3%	10.7%	13.6%
COMMODITIES									
Gold (US Dollars)	USD	16.3%	46.4%	45.3%	31.6%	15.0%	12.9%	14.9%	14.1%
Gold (Rands)	ZAR	12.9%	33.8%	45.4%	29.8%	15.8%	15.4%	15.3%	17.0%
CURRENCIES									
Rand / Dollar	ZAR	2.6%	8.7%	-0.2%	1.5%	-0.7%	-2.2%	12.1%	14.6%
Rand / GBP Pound	ZAR	4.4%	1.8%	-0.6%	-4.9%	-1.5%	-1.0%	9.8%	14.1%
Rand / Euro	ZAR	2.7%	-3.7%	-5.7%	-4.7%	-0.7%	-2.7%	9.6%	12.8%

KEY

Asset Class	Represented By:
SA Bonds	Satrix Bond Index Tracker
SA Cash	STeFi
SA Equity	Satrix ALSI Index Tracker
SA Listed Property	Satrix Property Index Tracker
Emerging Markets Equity	iShares Emerging Markets Equity Index Tracker
US Cash	Fidelity Institutional Liquidity The United States Dollar
Global Bonds	iShares Core Global Aggregate Bond ETF
Global Equity	iShares Developed World Index Tracker
Global Property	iShares Developed Real Estate Index Tracker

PENSHARE
INVESTMENTS (PTY) LTD

September 2025

Spot Rates		30-Sep-25	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago
CURRENCIES							
Rand/US$	Rand	17.3	18.4	17.2	16.7	13.8	6.4
Rand/GBP	Rand	23.2	23.7	23.1	21.6	20.9	11.2
Rand/EUR	Rand	20.3	19.9	19.2	19.6	15.4	7.7
RATES							
SOFR 6m $	US$	4.4	4.5	5.0	0.1	0.3	3.4
Repo Rate	Rand	7.00	7.50	8.00	3.50	6.00	7.00
Prime	Rand	10.50	11.00	11.50	7.00	9.50	10.50
All Bond Index Yield	Rand	9.2	9.9	11.6	11.6	8.8	9.7
COMMODITIES							
Gold ($/oz)	US$	3,833.9	3,125.3	2,634.0	1,899.8	1,114.3	470.9
Platinum	US$	1,571.0	993.0	985.0	884.0	908.0	929.0
Oil (Brent Crude) $	US$	67.1	74.8	72.0	41.0	47.9	62.1
INFLATION							
SA Inflation	%	3.3	3.2	3.8	3.1	4.5	9.4

data provided by FE Analytics