

ASAP

Legal and Technical Update

The living annuity (Retirement Income Option)

The Living Annuity is defined by the Income Tax Act. It is defined as follows:

It is a right of a member (or former member, dependent or nominee of that member), of a pension, pension preservation, provident, provident preservation or retirement annuity fund, to an annuity purchased from a person or provided by that fund on or after the retirement date of that member or former member in respect of which—

- a) the value of the annuity is determined solely by reference to the value of assets which are specified in the annuity agreement and are held for purposes of providing the annuity;
- b) the amount of the annuity is determined in accordance with a method or formula prescribed by the Minister by notice in the Gazette;
- c) the full remaining value of the assets contemplated in paragraph (a) may be paid as a lump sum when the value of those assets become at any time less than an amount prescribed by the Minister by notice in the Gazette;
- d) the amount of the annuity is not guaranteed by that person or fund;
- e) on the death of the member or former member, the value of the assets referred to in paragraph (a) may be paid to a nominee of the member or former member as an annuity or lump sum or as an annuity and a lump sum, or, in the absence of a nominee, to the deceased's estate as a lump sum; and
- f) further requirements regarding the annuity may be prescribed by the Minister by notice in the Gazette;

In addition the following pieces of legislation also apply to living annuities:

- Section 37A of the Pension Funds Act – an annuity purchased or to be purchased by the fund from an insurer for a member is non-transferable, non-commutable and it cannot be ceded or divided and the protection against creditors of an insolvent member.
- Section 37B of the Pension Funds Act – an annuity purchased by the fund from an insurer for a person does not form part of the insolvent estate of that person.
- General note 18 issued by SARS – imposing limitations on compulsory annuities insofar as it is non-commutable, transferable and bringing it under the application of section 37A and 37B of the Pension Funds Act.

- Directive 135 and 135A issued by the FSB (dealing with the transferability of living annuities between administrators).

The living annuity is not a registered retirement fund. It has the structure of a long term insurance policy purchased by a retirement fund or a member of a retirement fund and it is commonly referred to as a compulsory linked annuity.

Practical issues:

- The living annuity is either purchased by the individual member (“member owned”) or the retirement fund (“fund owned”). Most are member owned. This summary will focus on member owned living annuities.
- The annuitant can select the annuity level within legislated limits. Currently it is restricted to between 2.5% and 17.5% of the underlying investment value p.a. (See discussion below.)
- The annuitant can only alter income rate and the frequency of the payment of the income on the anniversary of the annuity.
- More than one fund source can be invested into a single living annuity (the funds from a retirement annuity fund, pension fund and provident fund, including preservation funds, can all be invested in one living annuity).
- The annuitant carries the investment risk associated with the living annuity as the underlying assets’ value is used to determine the value of the annuity. Therefore, if the investment value is depleted by negative investment returns, the annuity will reduce accordingly. There are no guarantees on investment performance.
- Regulation 28 to the Pension Funds Act does not apply to the underlying investment choices made by the annuitant and therefore there is no legislative limitation on the investment risk.

Income rate and frequency

In terms of paragraph (b) of the definition of living annuities, the income rate is limited to between 2.5% and 17.5% per annum.

The actual rates and other limitations are contained in Government Gazette 32005 of 11 March 2009. In terms thereof, the following rules and restrictions should be remembered when advising clients:

- The rate and frequency can only be altered once a year on the anniversary of the contract.
- If an annuitant adds to an existing living annuity from another retirement fund, the original anniversary date on the living annuity contract will prevail. The income payable to the annuitant will change at that point. The income is recalculated taking into consideration the amount received; investment date; next anniversary/review date; income percentage, income frequency; income amount and total incomes already paid. For example:
 - o Assuming there is R1m in a living annuity at an income rate of 10% and the anniversary date was 6 months ago (so another 6 to go) – total income for the year is R100 000 and R8 333 x 6 has already been paid.
 - o The annuitant now adds another R1m from his preservation fund to the same living annuity.
 - o At this time the income rate cannot be amended.
 - o The income will be adjusted to take the 10% into account on the new R1m payable for the 6 remaining months and the income will therefore be equal to R8 333 + R8 333 = R16 666 per month for the next 6 months.

- If an annuitant transfers a living annuity from another company to an existing living annuity with Momentum, the original anniversary date on the Momentum contract will prevail.
- The income received from the other company as is will be added to the Momentum contract's income.
- A transfer will only be possible if the two investments have the same income frequency. (A monthly paying investment cannot be added to a yearly paying investment). For example:
 - o Assuming there is R1m in a living annuity at an income rate of 10% and the anniversary date is 6 months ago (so another 6 to go) – so total income for the year is R100 000 and R8 333 x 6 has already been paid.
 - o The annuitant now transfers an existing living annuity to this existing Momentum living annuity of R1m but at an income rate of 5% - so the income is R4 166 per month.
 - o The income payable by Momentum for the duration of the 6 months until the anniversary date will be the R8 333 pm from the original Momentum contract plus R4 166 from the transferred living annuity.
 - o At the anniversary date, the rate applicable to the Momentum contract will prevail and be applied to the total R2m fund value - unless the annuitant selects a new rate all together, in which case the new rate will apply.
- If an annuitant transfers from another company's living annuity to a new Momentum living annuity, the original anniversary date of the transferred contract will be transferred into the new Momentum contract and the annuitant will be able to alter the rate at that time. Momentum will also retain the income rate from the old contract until such time as the anniversary date comes along, at which time the client can review the income rate.

Access to funds – annuitant:

- Should the investment value reach R50 000 (if a previous commutation was made) or R75 000 (if no commutation was made before), the annuitant can withdraw the full amount as a lump sum amount. No amendments have been made to the limits at the time of publication.
- SARS has records of previous commutations made and will only issue the tax directive accordingly.
- No withdrawal is allowed purely based on the annuitant's emigration. In that instance, the monthly annuity may be remitted offshore, depending on business requirements and SA Reserve Bank approval. Income tax will still be deducted.

Death of the annuitant:

- Upon the death of the annuitant, the nominated beneficiary/ies will be entitled to:
 - o continue with the annuity in their own name, or
 - o withdraw the full amount as a lump sum, or
 - o select a combination of the two options above.
- Each nominated beneficiary can make their own choice regarding the above options.
- Where no beneficiary is nominated, a lump sum will be payable to the estate of the deceased annuitant.
- The annuitant can nominate any person as a beneficiary – it is not limited to dependants (as defined by the Pension Funds Act).
- The beneficiary nomination can be amended by the annuitant at any time, as long as it is done in writing to the administrator and reaches the administrator prior to the death of the annuitant.

- Where a beneficiary is situated offshore, the lump sum or annuity can be paid to them (subject to exchange control regulations if applicable). In both instances, the after tax amount will be remitted and the process will be facilitated by a South African bank acting as an Authorised Dealer for the Reserve Bank, who will insure that all administrative and legislative requirements are met.
- The underlying asset value of the living annuity is not an asset in the estate of the deceased annuitant for estate duty purposes.

Trusts as beneficiaries

Some administrators of living annuities allow for the appointment of trusts as beneficiaries. There are some important points to remember when advising a client on this matter:

- There is a possibility that this option may be stopped in future, as SARS has indicated that living annuities are intended for natural persons only. However, there is currently no formal legislation to support this or to prohibit the practice of appointing a trust as a beneficiary.
- The trust will have the same options available as any other beneficiary – either take a cash lump sum or an annuity or a combination of both.
- Where a testamentary trust is nominated as a beneficiary, it is important to note that the income paid by the living annuity will cease until such time as the trust is registered and a bank account is opened.
 - This can take months as the executor first has to be appointed before the process can start.
 - Once the trust is registered and the trustees are authorised to act on behalf of the trust, they can elect to take a lump sum and/or to continue with the living annuity.
 - Where a lump sum is taken, the income tax will be paid as discussed in this document.
 - Where the living annuity continues, a new contract is issued in the name of the trust.
 - Momentum is obliged to withhold PAYE from the income, based on the status of the annuitant.
 - If the trust is a special trust (for minor children or disabled persons) PAYE will be similar to that payable by natural persons. If the trust is not a special trust, PAYE will be withheld at the trust's tax rate of 45%.
 - It is an option to give the trustees of the trust the power to take the annuity option and to make the investment in the name of the beneficiary directly, rather than in the name of the trust (this should be stipulated in the will under the powers of the trustees) – this is more viable where the trust has a specific end date – for example when all the beneficiaries are of a certain age.
- Where an *inter vivos* trust is nominated as a beneficiary, the following should be noted:
 - The trustees can elect to receive a lump sum or to continue with the living annuity or they can elect a combination of the two.
 - Technically, where the option is made to continue with the living annuity, a contract is issued in the name of the trust. In this case, PAYE is withheld based on the tax rate of the trust, which is 45%.
 - Alternatively, the trust can register as an employer in terms of the Fourth Schedule to the Income Tax Act.
 - In this instance, the trust will obtain a tax directive to instruct the administrator not to withhold any PAYE.

- The administrator will pay the gross annuity income to the trust. The trust will be liable to account for the PAYE and pay it to SARS based on the tax rate applicable to the beneficiary that receives the income from the trust. The administrator of the living annuity cannot assist with this process – the trustees must make this decision to register as an employer in terms of the powers bestowed on them in the trust deed and they should consult their accountant and tax practitioner to assist with this process.

Access to funds – third parties

Creditors:

Sections 37A and 37B of the Pension Funds Act specifically include annuities in its application. These sections provide protection to the benefits in a retirement fund and a compulsory annuity. The assets in a living annuity are therefore not accessible by creditors.

Divorce – division of retirement assets:

When considering the impact of divorce on a living annuity, one has to consider the Divorce Act, read with section 37D of the Pension Funds Act. In terms of the Divorce Act, a person's pension interest is taken into account for division of asset purposes (applies to communal marriages and accrual marriages only).

A living annuity is not included in the definition of a pension interest, and therefore, it is not considered when determining the division of pension interests. This interpretation is strengthened by the recent Appeal Court case *ST vs CT*. In this case it was determined that a living annuity does not form part of the divisible assets upon divorce. The reason provided is that the living annuity 'asset' belongs to the insurer and not the annuitant and that the annuitant merely has a right to the income and not the capital during their lifetime.

However, the living annuity income can be considered for maintenance purposes – please note that the insurer cannot split the income between an annuitant and an ex-spouse and the annuitant will be liable to make the maintenance payment to the ex-spouse.

Income Tax Implications

The annuity

The monthly annuity income that is payable to the annuitant will form part of his gross income in terms of paragraph (a) of the definition of "gross income" in the Income Tax Act.

This will also apply where the annuity is paid to a nominated beneficiary. The result is that this income is taxed in accordance with the income tax table applicable to the annuitant.

The withdrawal

Where the annuitant withdraws the total value from the living annuity (after retirement and prior to death - where the fund value reaches R50 000/R75 000 as discussed above), the lump sum will be included in the gross income of the annuitant and will be taxed in terms of the Second Schedule to the Income Tax Act; the retirement tax table will apply. The lump sum amount will be reduced by all contributions made by the annuitant to a retirement fund that did not rank as a tax deduction.

Upon the death of the annuitant, where a nominated beneficiary/ies elect to make a lump sum withdrawal after the death of the annuitant (as opposed to continuing with the annuity), the Second Schedule of the Income Tax will apply.

The total lump sum is deemed to have accrued to the deceased annuitant immediately prior to his/her date of death. This applies irrespective of whether the deceased annuitant is the original owner of the living annuity or subsequent beneficiaries.

The lump sum will be taxed according to the retirement fund lump sum tax table that applies in respect of retirement and death. The beneficiary will receive the lump sum from the administrator net of tax.

Estate Duty Implications

The living annuity is not included in the estate of the annuitant for estate duty purposes. Section 3(2)(b) of the Estate Duty Act states that any right to an annuity enjoyed by the deceased immediately prior to his death which accrued to some other person on the death of the deceased, forms part of the deceased's estate. However, section 3(2)(i) contains the exclusion and reads as follows:

“but does not include—

(i)so much of any benefit which is due and payable by or in consequence of membership or past membership of, any pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund as defined in the Income Tax Act, 1962 (Act No. 58 of 1962), on or as a result of the death of the deceased.”

Therefore the living annuity is exempt from estate duty. This rule applies to the living annuity, irrespective of whether the deceased is the first original annuitant or a subsequent annuitant due to a beneficiary nomination.

Executor's Fees

Where the living annuity is paid directly to the nominated beneficiary, no executor's fees will be payable on the asset. However, if no beneficiary is nominated and the living annuity pays out as a lump sum to the deceased's estate, executor's fees will be payable on that amount.

Disclaimer: The views and/or opinions expressed in this document have been prepared as a primary source of information and are not a recommendation for the conclusion of a transaction. This document has been prepared for general information and not having regard to any particular person's financial or investment needs and objectives. No representation is given, warranty made or responsibility taken as to the accuracy, timeliness or completeness of any information contained in this email and Momentum Metropolitan Life Limited will not be liable in contract or in delict or otherwise for any loss or damage arising as result of the reader relying on any such information (except in so far as any statutory liability cannot be excluded).