LIVING ANNUITIES

Legal and Tax Implications

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Living Annuities

General

- Not a registered retirement fund.
- Structure of a long term insurance policy purchased by a retirement fund or a member of a retirement fund.
- Compulsory linked annuity.

Living Annuities

Practical issues:

- Either purchased by the individual member (“member owned”) or the retirement fund (“fund owned”).
- Most are member owned.
- This presentation will focus on member owned living annuities.

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Practical issues:

- 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).

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Practical Issues

- 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.

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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.

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- 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 income already paid.

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For example:

- 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.
- The annuitant now adds another R1m from his preservation fund to the same living annuity.
- At this time the income rate cannot be amended.
- 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.

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- 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.

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- 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:
- 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.

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- 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.

- 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.

- 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.

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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.
- 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.

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Death of the annuitant:

Upon the death of the annuitant, the nominated beneficiary/ies will be entitled to:

- continue with the annuity in their own name, or
- withdraw the full amount as a lump sum, or
- select a combination of the two options above.

Each nominated beneficiary can make their own choice regarding the above options.

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Death of the annuitant:

- 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.

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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.

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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

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Income Tax Implications

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 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.
- 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.

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Income Tax Implications

The withdrawal

- The total lump sum is deemed to have accrued to the deceased annuitant immediately prior to his/her date of death.
- 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.

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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.

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Estate Duty

- 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."

- 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.

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Trusts as Beneficiaries

- Some administrators of living annuities allow for the appointment of trusts as beneficiaries.
- 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.
- 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.

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Trusts as Beneficiaries

Testamentary Trust

- 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 previously.
- Where the living annuity continues, a new contract is issued in the name of the trust.

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Trusts as Beneficiaries

Testamentary 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.

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Trusts as Beneficiaries

Inter Vivos Trust

- 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%.

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Trusts as Beneficiaries

Inter Vivos Trust

- 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.

Protection against Creditors

- Sections 37A and 37B of the Pension Funds Act specifically includes 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.

Protection against 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.
- 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.

THANK YOU

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