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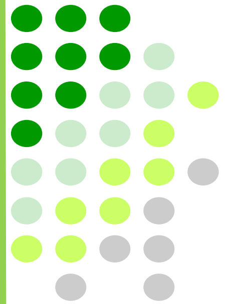

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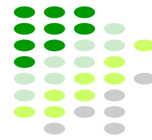

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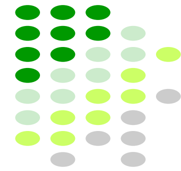

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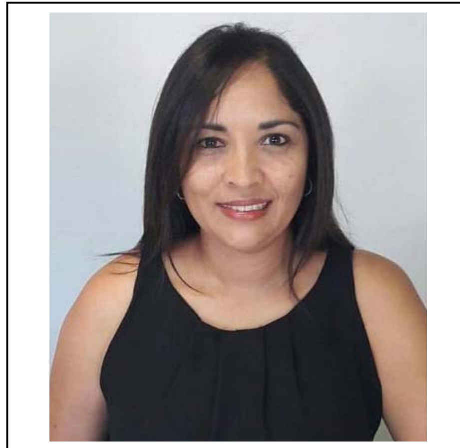

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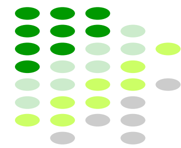

Contents

Estate Planning

Is the use of preference shares still an option for estate planning? **A1 – A7**
Petri Lourens

Legal position of mentally incapacitated persons – a need for law reform **A8 – A17**
Anél Strampe

Foreign life insurance policies and the estate duty implications **A18 – A27**
Carla Letchman

Pitfalls in the wording of certain clauses and conditions in wills **A28 – A37**
Chris Du Plessis

Trustees and the power to delegate their duties **A38 – A44**
Daleen Harris

A sequence of events – A practical discussion of the Life insurance contract **A45 – A55**
Louw du Toit

Mauritian trusts – Estate planning tool or not? **A56 – A64**
Stephan Van Zyl

Business Assurance Planning

Share buy-back agreements vs traditional buy-and-sell agreements **B1 – B23**
Chantel Strauss

Income Tax

Taxability of claims for damages and compensation **C1 – C11**
CJ Le Roux

Salary vs. Dividends vs. Loans – How to receive the profits from the business? **C12 – C18**
Keith Peter

Retirement annuity deductions for SA Tax residents earning foreign remuneration **C19 – C25**
Old Mutual Personal Finance: Legal

South African Residents working abroad: An income tax perspective **C26 – C44**
Rifaat Jarodien

Intellectual property in financial planning **C45 – C51**
Saudiqa Fakier

Investment Planning

Section 12 J Investments **D1 – D12**
Madeleine Britz

Retirement Planning

Implications of a section 197 transfer on retirement benefits **E1 – E7**
Jothi Chirkoot

Taxation of public sector funds **E8 – E21**
Charlotte van der Merwe

Divorce & retirement benefits **E22 – E48**
Karen van der Poll

Living Annuities: A summary of the status quo **E49 – E69**
Suzelle Jooste

General

'Uthando Nesthembu'… The proprietary consequences of polygamous customary marriages **F1 – F9**
Gerald Peter

The accrual claim at death vs divorce **F10 – F21**
Natalie Dillon

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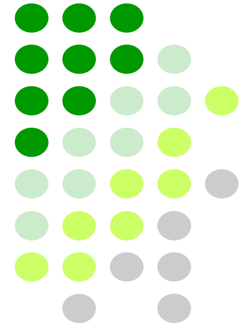

Estate Planning

Is the Use of Preference Shares Still an Option for Estate Planning?

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Introduction

One of the primary objectives of estate planning is to minimise the estate duty and taxes payable upon death. One of the means used by planners to peg a client's estate involves a plan which combines the use of a trust with a company. The plan is set up that the founder is given voting preference shares that are not equity shares. A preference share is a class of share which permits the holder a preference over the share classes with regards to the payment of dividends and at times return on capital upon winding up.[1] The founder could run the business as he saw fit by using his preference shares for voting purposes while the trust holds the equity shares, ensuring that the founder's control of the company can only be for the benefit of the trust.[2] The founder is put in a position where he is able to dispose of the assets of the company without giving rise to the application of section 3(3)(d) of the Estate Duty Act[3].

Section 3(3)(d) includes within the deemed property of a deceased person any property which the deceased, immediately prior to his death, was competent to dispose of for his own benefit or for the benefit of his estate. Simply put, the estate of the deceased could be liable for estate duty on the property which did not technically belong to him if he had the power to dispose of that property for his own benefit or the benefit of his estate during his lifetime. As the founder does not hold any ordinary shares, any disposal of assets of the company can only be for the benefit of the trust. No material benefit of the disposal can pass to the founder and therefore no application of section 3(3)(d) of the Estate Duty Act.

A recent judgment by the Supreme Court of Appeal in C: SARS v The Executors of Estate Late Sidney Ellerine[4] called the viability of the use of preference shares for the pegging of an estate into question. An important part of the estate pegging plan is that the preference shares are not able to be converted into ordinary shares. If the preference shares can be converted into ordinary shares the result is that the valuation of the shares for the purposes of capital gains tax will be market value over base cost. The finding can be applied analogously to the valuation of preference shares for purposes of estate duty.[5] This article will critically analyse the court case and question if planners should still make use of this structure for estate planning purposes since, it is very important that the correct sequence and structuring of the plan is followed to ensure that adversarial consequences will not occur as in the Ellerine case.

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[1] Davis et al 2011: 67 and 402.
[2] Haupt 2019: 886.
[3] 45 of 1955.
[4] 2018 ZASCA 39.
[5] Davis et al 2019: 13.

C: SARS v The Executors of the Estate Late Ellerine

The SCA upheld an appeal against an order of the Gauteng Tax Court concerning the valuation of preference shares for the purposes of determining a capital gain in terms of paragraph 40[6] read with paragraph 31(3)(a)(i) of the Eighth Schedule to the Income Tax Act[7]. The facts of the case are as follows: The deceased, Sidney Ellerine, held 112 000 R1 preference shares in Sidney Ellerine Trust (Pty) Ltd. Six hundred ordinary shares in the company where held by four family trusts. Each of the ordinary shares and each of the preference shares held one vote.[8] The Commissioner assessed that value of the preference shares on the foundation that the share accounted for 99,47% of the share capital of the company. The deceased thus had 99,47% of the voting rights at shareholder meetings.

The estate opposed this assessment on the basis that there were special conditions in the articles of incorporation of the company providing that the deceased was precluded from converting the preference shares into ordinary shares without votes in support of at least 75% of the ordinary shareholders. The company amended the Articles of Association in 2006 to include special condition 5.8 which provided that Article 34 (containing the rights of the redeemable non-cumulative preference shares) could be amended with the prior written approval of at least 75% of each class of shares in the issued share capital. The amendment was done with the intention of protecting the ordinary shareholders in the company to the terms of the preference shares which might impact their rights as shareholders.[9]

Article 4.2 allowed the variation of any rights attaching to a share with the consent of 75% of the shareholders of that class of share. Another important clause in the company's articles of association was Article 7.10 which provided that a special resolution may convert any shares in the capital of the company to shares of a different class, and in particular convert ordinary shares or preference shares to redeemable preference shares. The executors of the estate declared the disposal of the preference shares held by the deceased in the income tax for the year of assessment that ended on the date of his death. The value of the preferences shares was submitted by the executors of the estate as R112 000, being the par value of the shares. SARS

[6] This section applied to persons who died before 1 March 2016 and provides that when a person dies, that person is deemed to have disposed of all of his or her assets at an amount equal to the market value of such assets. Sections 9HA and section 25 apply to persons who die on or after 1 March 2016.
[7] 58 of 1962.
[8] Webber Wentzel 2018: 5.
[9] Webber Wentzel 2018: 5-6.

disagreed and valued the shares for an amount equal to the market value of 99.47% of all the shares of the company, which amounted R563 000 000.[10]

There were two issues before the SCA: The first was whether the rights that attached to the preference shares could convert these shares into ordinary shares without the amendment to Article 34 of the Articles of Association, which read with special condition 58, required the written approval of 75% of the holders of each class of shares of the company. Secondly the court was to determine whether, in terms of Article 4.2, conversion of the deceased preference shares to ordinary shares could take place without the approval of 75% of the holders of the ordinary shares.[11] The deceased was deemed to dispose of his preference shares at market value on the date of his death, and the issue was whether the ease of conversion of the preference shares into ordinary shares was the decisive factor as to whether the preference shares should be valued in the same manner as the ordinary shares.[12]

The appeal was upheld with costs.[13] The SCA held that: "any interpretation regarding a company's articles must be located within the context of the nature of the articles of association which confer rights or impose obligations on persons who are members. It is clear that the deceased, by virtue of holding an overwhelming majority of the votes, could have converted the preference shares to ordinary shares."[14] The result was that the value of the preference shares was R563 400 000 instead of R112 000.

This case is an example of how amendments to the memorandum of incorporation of a company may give rise to unintended tax consequences, even though the intention of the plan was to ensure advantageous tax consequences.

The importance of the correct structure

Section 3(3)(d) of the Estate Duty Act[15] deems property of the deceased to include property which the deceased was, immediately prior to his death, competent to dispose of for his own benefit or for the benefit of his estate. The use of preference shares by planners to avoid the property being included as deemed property, but still have enough voting power to run the

[10] https://www.pwc.co.za/en/assets/pdf/synopsis-march-2018.pdf
[11] The Registrar of the SCA 2018: 1.
[12] Webber Wentzel 2018: 6.
[13] Paragraph 39.
[14] Paragraph 33.
[15] 45 of 1955.

business as they see fit, can go wrong if not implemented correctly. Haupt[16] sets out a structure and sequence to be followed by planners to ensure the desired result:

- The formation of the trust by the founder who will donate a nominal amount to the trust.
- The trust will promote the formation of a company and subscribe for 450 ordinary shares (100% of the share capital).
- The 'founder' will subscribe for 500 (100%) non-participating preference shares which each carry a vote. It is important that the preference shares are not able to be converted into ordinary shares." This important fact was overlooked by the deceased and his advisors in the Ellerine matter.
- The assets will be transferred into the company from the 'founder' either by means of sale of donation or in exchange for the issue of preference shares.

The effect of the correct structuring will be that the trust is the holder of 100% of the equity (ordinary) share capital, and all growth in assets will therefore accrue to the trust and not to the founder. The preference shares that have been issued to the founder will enable him or her to have greater voting power, and such founder will be able protect the assets and make decisions as he or she sees fit. The preference shares are non-equity shares and will not increase in value should the assets grow in value and the equity (ordinary) shares will not constitute deemed property upon death of the founder. The beneficiaries of the trust will not have any vested rights and will thus also protected from potential estate duty liability. If the value of the preference shares given to the founder is less than the value of the assets that he gives to the company, the founder will be liable for donations tax. There may also be capital gains tax payable by the founder in respect of assets transferred to the company by the founder.[17]

Where a person sells assets to a company in exchange for preference shares as part of an estate planning exercise, it is important that such person is receiving fair value for his assets to ensure that he or she will not be deemed to be making a gratuitous disposal, that will give rise to donations tax in terms of section 58 of the Income Tax Act.[18]

Conclusion

It is submitted that the use of preference shares in estate planning remains a viable option if structured correctly. The rights conferred on the holder of the preference shares are dependent

[16] Haupt 2019: 886-887.
[17] Haupt 2019: 887.
[18] Davis et al 2019: 13.8.

on the wording in the memorandum of incorporation of the company. For the plan to be successful, the preference shares must be non-participating preference shares and the memorandum of the company must not enable the holder to switch to another class of shares.

Planners are constantly in search of ways to ensure the best tax consequences for clients. Some structures used are complex and should be handled with care. The Ellerine case is an example of how a small detail in the memorandum of incorporation of a company can cause the opposite effect of what was intended. The risks involved in using preference shares as an estate planning tool without the necessary knowledge of how the plan should be executed is great. Planners must act with care and understand the application of legislation and the provisions of relevant documents related to the company before advising a client to make use of preference shares for this purpose.

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Legal Position of Mentally Incapacitated persons – A Need for Law Reform

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Introduction

According to a report conducted by the World Health Organization one in four persons will be effected by mental or neurological disorders in some point of their lives.[1] In the financial services industry we are often faced with situations where a client has become legally incompetent to manage their own affairs. The capacity of an individual to enter into legal transactions and to make decisions is closely related to the mental condition of that individual. For a legal transaction to be valid the law requires that a person must be able to understand the nature, purpose and consequences of their actions. Where any of these requirements are absent the law attaches no legal consequences to such transaction. The aim of the law is not to be seen as to punish the mentally incapacitated but rather as a legal measure to protect persons against exploitation of others.

The fact that mentally incapacitated persons cannot enter into legal transactions results in the instance that another person must act on their behalf. No person is naturally able to act on behalf of another without the required authority do to so. A power of attorney is generally how this authority is given to another.

A misguided perception exists that a power of attorney by a mentally incapacitated person to enable another to act on their behalf is legal and binding. In terms of the law, an authorised agent of a person cannot perform any act that the principle has no legal capacity or mental soundness to perform themselves. [2] In South Africa the power of attorney remains valid only for as long as the principal is still capable of appreciating the concept and consequences of granting another person his or her power of attorney. The moment a person becomes mentally incapacitated and is no longer capable of managing his or her own affairs, the power of attorney lapses. Therefore, the power of attorney losses it's legal authority when the principle becomes mentally ill. If an agent continues to act on behalf of another in terms of a void power of attorney, that person could be held personally liable for any losses suffered by a third party. Many financial advisors are not aware that a power of attorney loses its legal power when a person becomes mentally incapacitated and they could expose themselves to serious advice risks.

The law provides two vastly different options to enable another to legally act on behalf of a mentally incapacitated person, namely: appointing an administrator or curator in terms of

[1] https://www.who.int/whr/2001/media_centre/press_release/en/
[2] Gordini 2018: 1.

common law, or to apply to be appointed as an administrator for that person in terms of the Mental Health Care Act of 2002. This article will critically examine both procedures and confirm the need for law reform on this matter.

Mental Incapacity

Mental incapacity is primarily the result of either mental illness (which includes acquired organic brain syndromes such as dementia of which the most common form is Alzheimer's disease) or intellectual disability. Mental incapacity may however also be related to the process of ageing in general[3]. "Mental illness" can take many forms but can be distinguished from "intellectual disability" in that the mental illness can usually be treated and a recovery may be possible, although not in all circumstances**.**

Appointing a curator in terms of common law

The procedure is set out in Rule 57 of the Rules of the High Court in respect of mentally ill or mentally deficient persons; persons, who owing to physical infirmity cannot manage their own affairs; and persons declared prodigals.[4]

In terms of the common law the High Court may declare a person incapable of managing his or her own affairs and may appoint a curator to the person and or property of that person. A notice of motion must be filed (by any person who has interest in the individual's affairs) containing the personal particulars of the person, affidavits relating to the circumstances of the individuals impairment and the income, expenditure, assets and liabilities. Two recent medical reports by medical doctors is also required. The court will then appoint an official *curator ad litem*, usually an advocate of the court, to investigate the matter and draft a report for the court and the Master.[5] This mechanism is put in place to prevent abuse of the procedure and the purpose is that the *curator ad litem* must confirm that the person is in fact not able to manage their own affairs and that the appointment of a *curator bonis* will be in the best interest of the individual.[6] Thereafter, the Master also compiles a report for the court regarding the merits of the case, the sustainability of the nominated curator and his powers and security.[7] A *curator bonis* is the curator appointed to administer the estate of a person declared incapable of managing his own

[3] SALRC Discussion Paper 105 on Assisted Decision-Making: Adults with Impaired Decision-Making Capacity
[4] Van Heerden et al 1999: 148.
[5] Rule 57 (4) and (5).
[6] Jacobs 2018: 4.
[7] Rule 57(7).

affairs. A *curator bonis* is not appointed to act on behalf of another in matters relating to the care, custody and welfare of a person which is the function of a *curator personae*. A *curator bonis* for example, cannot make a valid will or enter into an action for divorce on behalf of another.[8] Such person may only act on the appointment after he or she is formally authorized by the Master of the High court.[9] The *curator bonis* is usually an attorney of the court and the Master does not favour appointing a close family member.

A person that has been declared mentally ill and have been appointed a curator does not lose all capacity to act. In *Pienaar v Pienaar's Curator*[10] it was held that a person that has been placed under curatorship can enter into a valid legal transaction with its normal consequences if, at that particular moment, that person was physically and mentally capable of doing so. The burden of proof lies with the person who alleges that the person under curatorship had the necessary capacity to act. Therefor a person's capacity to act may differ from day to day but always remain a question of fact.[11] A *curator bonis* must administer the estate of the person in respect of whom he or she is appointed in accordance with the powers and functions grated by the court.[12]

The High Court application is very costly and usually involves the appointment of an advocate. The average costs range between R40,000 and R60,000 and is usually borne by the estate of mentally incapacitated person. Most people simply do not have sufficient funds to go this route. The whole process is cumbersome in that all actions taken by the appointed curator must first be approved by the Master of the High Court. The Curator must also submit an annual report to the Master called a Curatorship Account that must set our all the income and expenditure during the last year with receipts attached.

Appointing an administrator in terms of the Mental Health Care Act of 2002

Another procedure came to light when the Mental Health Care Act came into operation on 15 December 2014. The act provides for the appointment of an administrator to care for and administer the property of a person who is mentally ill or a person with severe or profound intellectual disability. Section 1 of the act defines "mental illness" as "a positive diagnosis of a

[8] Meyer 2016: 5-6.
[9] Bouwer NO v Saambou Bank Bpk 1993 SA 492 (T).
[10] 1930 OPD 171.
[11] Pienaar v Pienaar's Curator 1930 OPD 171 174-175.
[12] Meyer 2016: 22.

mental health related illness in terms of accepted diagnostic criteria made by a mental health care practitioner authorised to make such diagnoses". Severe or profound intellectual disability means "a range of intellectual functioning extending from partial self-maintenance under close supervision, together with limited self-protection skills in a controlled environment through limited self-care and requiring constant aid and supervision, to severely restricted sensory and motor functioning and requiring nursing care". The difference between mental illness and severe and profound intellectual disability is that persons who are mentally ill previously had been mentally able and the illness can be treated and in some cases even cured. Persons suffering from intellectual disability have never been mentally able due to a range of factors prior to birth, at birth or during childhood up to the age of brain maturity, affecting their intellectual development. Treatment and cure is usually not possible.[13]

Since a diagnoses of mental illness or severe or profound intellectual disability is a prerequisite person who is mentally incapacitated to manage their own affairs because of serious illness, old age or a physical disability are excluded from the act and those persons will still have to apply to the High Court for a curator to be appointed.

The application procedure for the appointment of an administrator in terms of the Mental Health Care Act is set out in section 60 of the Act and provides as follows:
60(1) "any person over the age of 18 may apply to a Master of the High Court for the appointment of an administrator for a mentally ill person or person with severe or profound intellectual disability."

Similar to the common law procedure the act states that application must be made in writing and under oath and must contain the personal particulars of the person, medical reports and certificates and the property value and annual income of the person.[14] The applicant initiates the procedure by completing a three-page form MHCA 39/CB11 that is available at the Masters office as well as the official website of the Master. The applicant must also attach proof that a copy of the application has been submitted to the mentally ill person.[15] This requirement was put into place to prevent malicious applications where the person in respect of whom the

[13] Meyer 2016: 9-10
[14] Section 60(2)(a)-(f).
[15] Section 60(3).

application was made had no knowledge of such an application and results in an infringement of his or her fundamental right to manage his or her own affairs independently.[16]

If the Master is satisfied based on the application submitted no further investigation is necessary and the mentally ill person or person with severe or profound intellectual disability's capital assets is below R200,000 or income is below R24,000 per annum. If the value of the person in question's assets and income is above the mentioned amounts or there are certain allegations in the application that require further investigation the Master must appoint an interim administrator and conduct further investigation before an administrated is appointed. In terms of section 63(3) of the Act the powers of an administrator are to take care of and administer the property of the person for whom he or she is appointed and to carry on any business or undertaking of that person, subject to any other applicable law.

Because persons can initiate the procedure directly with the Master is a lot less costly and time efficient than the common law application to the High Court. The costs will be borne by the estate of the person placed under administration.

Special Trusts

An alternative to the appointment of a curator or an Administrator as mentioned above is the creation of a special Trust. The estate, or part of the estate, of a person lacking capacity will be controlled by trustees but solely for the benefit of the relevant person or persons. This solution thus overcomes the difficulties and limitations of going the Power of Attorney route as well as avoiding the cumbersomeness of a curatorship.

The Income Tax Act defines a Special Trust Type A as: *"a trust created solely for the benefit of a person(s) with a "disability" as defined in section 6B(1), where the disability makes it impossible for the person(s) from earning enough money for their care or from managing their own financial matters".* Section 6B(1) defines a disability as: *"a moderate to severe limitation of a person's ability to function or perform daily activities as a result of a physical, sensory, communication, intellectual or mental impairment. The disability must be diagnosed by a duly registered medical practitioner, and that disability must have lasted or has a prognosis of lasting more than one year."*

[16] Meyer 2016: 20.

A special trust can only be created by way of an agreement between the founder and the trustees whereby assets are transferred to the trust to be administered by the trustee for the benefit of the beneficiary – in this instance a disabled person. The special trust must be created during the life of the disabled person and be solely for the benefit of that individual. The advantage of the special trust is that the trustees administer the assets of the disabled person without the limitations of a power of attorney or going through the procedures described above. A recent Binding Private Ruling by SARS[17] set out the consequence of a cash transfer made to a special trust. The applicant was an individual suffering from early onset of dementia but still had the capacity to contract.

A discretionary trust was set up for the applicant as the primary beneficiary and his decedents as secondary beneficiaries who will only benefit from the trust after the passing of the applicant. The applicant wanted to transfer an amount to the trust that did not amount to his entire estate. SARS ruled that the amount transferred by the applicant will not constitute a donation as contemplated in sections 54 and 55 of the Income Tax Act and no donations tax will be levied. Special trusts are taxed more favourable than other trusts. Income is taxed on a sliding scale same as natural persons (between 18% and 45%). Capital gains tax for special trusts is also taxed on a natural person's inclusion rate and also quality for the primary residence exclusion and yearly abatement of gains.[18] The special trust is not a viable solution for persons already suffering from mental incapacity but may be useful as a remedy in anticipation of incapacity.[19]

Enduring Power of Attorney

In certain jurisdictions it is possible, in anticipation of incapacity, to grant Power to an agent, which Power will then remain in force, despite incapacity. These Powers of Attorney are designated by different names in different jurisdictions, such as: A Lasting Power of Attorney, a Continuing Power of Attorney or an Enduring Power of Attorney.

For many years the South African Law Commission has been investigating the matter. The current position is strongly criticized by disability activists and is seen as being paternalistic in nature.[20] In 2004 a detailed report by the Commission entitled: Assisted Decision Making: Adults with Impaired Decision-Making Capacity and recommended legislation for an Enduring Power of

[17] BPR 306 Dated 28 June 2018.
[18] https://www.sars.gov.za/ClientSegments/Businesses/Trusts/Pages/Types-of-Trust.aspx
[19] Jacobs 2018: 6.
[20] Meyer 2016: 24.

Attorney to be introduced into our law both in respect of an individual's person and estate. Draft legislation was submitted to the Minister of Justice on September 2016. An Enduring Power of Attorney legitimises the common belief that seems to exist amongst family members and carers of persons that a power of attorney continues to be fully legal after a person loses their mental capacity to act. Other advantages of an Enduring Power of Attorney is set out in the report as follows:

- It is a device that has the virtues of privacy, simplicity and cheapness - in contradistinction to the complex, cumbersome and expensive Court procedure to have a curator appointed. It is especially useful in situations where the extent and value of the incapacitated person's assets do not warrant the greater expense associated with other mechanisms such as curatorship and trusts. Because of its relative simplicity, and the possibility of the availability of a standard form, the preparation and execution of an enduring power of attorney can generally be accomplished at minimal cost.
- It is a convenient mechanism. An agent, who has for example been managing the affairs of an elderly relative, is familiar with the affairs of the principal, is presumably trusted by the principal, and is therefore in the best position to continue the management role after the onset of incapacity.
- It is a flexible mechanism in that it can be tailored to the individual needs and wishes of the principal.
- It allows the principal to plan for the future. When a person has the foresight to make arrangements for his or her impending incapacity, it is most unsatisfactory if the law frustrates that planning. The enduring power provides a mechanism whereby a person can plan in advance for possible incapacity. The need for this concept is particularly pressing in a graying population.
- It acknowledges and emphasises the right to autonomy in allowing the principal to choose who is to manage his or her affairs. It is in fact the only way in which a person may nominate his or her own substitute decision-maker.
- It is often difficult to determine at what point a principal becomes incapable. An elderly person, with Alzheimer's disease for instance, will have periods of lucidity and periods of confusion. This can continue for years. Permitting an agent, who has been appointed with this possibility in mind, to continue to operate the power whether the principal is competent or not, avoids the need to determine when the person would be classed as legally incapable.
- It avoids the stigma of the principal having to be declared incapable (which is often a prerequisite of other mechanisms).

- It would reduce the pressure on any alternative mechanism already in place (eg the curatorship system), or any other alternative to be developed in that it would reduce the workload of the Courts and public offices which would administer and supervise such mechanisms.
- If a suitably informal but sufficiently monitored system of enduring power of attorney could be put in place, it could encourage family and carers of persons with incapacity, who have been intimidated by the more complex curatorship system, to undertake the formal care of the principal. If this is achieved the enduring power of attorney would fulfil a social role which reflects the needs of time."[21]

Critics argue that a more formal procedure is required to protect persons after they have become mentally incapacitated from exploitation.

Conclusion

It is clear that the current legal position is not sufficient. The curatorship procedure is too expensive for most South Africans and the Mental Health Act procedure is also not sufficient if the definitions are not met. A special trust can be used only if preparations are made in advance. Law reform has been horizon for many years and hopefully new law will be promulgated to address the legal position of mentally incapacitated persons in the near future.

[21] South African Law Reform Commission 2004: 124.

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Foreign Life Insurance Policies and the Estate Duty Implications

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Introduction

There are individuals who have foreign life insurance policies in various jurisdictions who reside in South Africa. The reason that this could be the case is because they have obtained it prior to coming to live in South Africa or they might have certain obligations in the other jurisdiction that the policy is intended for. The question then arises as to how would these life insurance policies be treated at their death?

This question will be answered with the below case study:

Tony Stark is 48 years old and currently resides in South Africa. He was born in Namibia, and has only resided there, prior to moving to South African ten [10] years ago. Tony is married out of community of property to Pepper Potts. They have one minor child. Tony would like to leave the residue of his estate to Pepper when he dies. Tony would like to know what are the costs payable at death and in particular how will his Namibian life insurance policy be treated. Tony acquired the life insurance policy after coming to South Africa. There is no beneficiary nominated on the policy. The deceased estate has a claim against the foreign insurer for the payment of the proceeds of the policy. Tony intended, and still does believe, that he will not return to Namibia and that South Africa is his home. Tony's assets are as follows:

Assets

Primary residence	R 3 500 000.00
Vehicle	R 400 000.00
Cash	R 100 000.00
Unit Trusts	R 200 000.00
Namibian life insurance policy	R 5 000 000.00

Liabilities

Outstanding bond	R500 000.00
Vehicle finance	R100 000.00

Estate Duty calculation

Property

Primary residence	R3 500 000.00
Vehicle	R400 000.00
Cash	R100 000.00
Unit Trusts	R200 000.00
Namibian life insurance policy	R5 000 000.00 ***[explained below]***
Total property	R9 200 000.00

Less: Deductions

Administration costs R110 454.00 [Transfer cost for primary residence R43 454 + Master's fees R7000 + Funeral cost R50 000 + General Administration cost R10 000.]

Executor's fees[1] R370 760.00 [R9 200 000.00 × 4.03%]

Liabilities R600 000.00 [Outstanding bond R500 00.00 + vehicle finance R100 000.00]

Capital Gains Tax [] R0 [Primary residence R3 500 000.00 – base cost = R1 500 00.00 The primary residence exclusion is R2 000 000.00 seeing as the gain is less no CGT is attributable. Unit trusts R200 000.00 – base cost R40 000.00 = R160 000 This is less than the R300 000.00 exclusion at death and therefore there is no CGT attributable

Section 4(q) R8 118 786.00 [see note 1]

Less: Section 4 A abatement	R3 500 000.00
Dutiable estate	R0
Estate Duty payable [20%]	R0

Note 1:

Calculation of residue

Assets	R9 200 000.00
Less:	
Liabilities	R600 000.00
CGT	R0
Executor's fees	R370 760.00

[1] Executors fees is 3.5% of the gross value of the assets in the estate plus 15% VAT; that gives you the percentage 4.03%

Administration costs R110 454.00

Residue before estate duty R8 118 786.00

The section 4(q)[2] deduction applies to any benefit that the spouse receives from the deceased, provided that it has not already been deducted.

The treatment of the foreign life insurance policy explained

If the individual *was* ordinarily resident in South Africa at the time of their death, then both local and foreign assets, are included as property and therefore dutiable. If the individual had a local life insurance policy, then that would be included in their deceased estate as deemed property; as per section 3(3)(a) below:

'(3) Property which is deemed to be property of the deceased includes-

(a) so much of any amount due and recoverable under any policy of insurance which is a "domestic policy", upon the life of the deceased as exceeds the aggregate amount of any premiums or consideration proved to the satisfaction of the Commissioner to have been paid by any person who is entitled to the amount due under the policy, together with interest at six per cent per annum calculated upon such premiums or consideration from the date of payment to the date of death: Provided that the foregoing provisions of this paragraph shall not apply in respect of any amount due and recoverable under a policy of insurance

*'**"domestic policy"** means any life policy as defined in section 1 of the Long-term Insurance Act, 1998 (Act No. 52 of 1998), issued anywhere upon an application made or presented to a representative of an insurer (or to any person on behalf of such a representative) at any place in the Republic, excluding a life policy which has been made payable at a place outside the Republic at the request of the owner, but including any life policy issued outside the Republic which has subsequently been made payable in the Republic at the request of the owner.'*[3]

*'**"life policy"** means a contract in terms of which a person, in return for a premium. undertakes to—*

(a) provide policy benefits upon, and exclusively as a result of a life event; or

(b) pay an annuity for a period;

(c) and includes a reinsurance policy in respect of such a contract;'[4]

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[2] Estate Duty Act No 45 of 1955 section 4 provides for deductions

[3] id section 1

[4] Long Term Insurance Act 52 of 1998 section 1

The Estate Duty Act, as seen above, provides that only a domestic policy will be included as deemed property in the deceased estate at death. Therefore, a foreign life insurance policy is not deemed property in a person's estate on his or her death. The policy is, however, still an asset in the estate of the deceased at death and needs to be accounted for. In terms of the Estate Duty Act[5]; the following constitutes property:

*"**3. What constitutes an estate.** -(1) For the purposes of this Act the estate of any person shall consist of all property of that person as at the date of his death and of all property which in accordance with this Act is deemed to be property of that person at that date.*

(2) "Property" means any right in or to property, movable or immovable, corporeal or incorporeal, and includes-

(a) any fiduciary, usufructuary or other like interest in property (including a right to an annuity charged upon property) held by the deceased immediately prior to his death;

(b) any right to an annuity (other than a right to an annuity charged upon any property) enjoyed by the deceased immediately prior to his death which accrued to some other person on the death of the deceased,

(bA) so much of the amount of any contribution made by the deceased in consequence of membership or past membership of any pension fund, provident fund, or retirement annuity fund, as was not allowed as a deduction in terms of section 11 (k) or (n) of the Income Tax Act, 1962 (Act No. 58 of 1962), or paragraph 2 of the Second Schedule to that Act or, as was not exempt in terms of section 10C of that Act in determining the taxable income as defined in section 1 of that Act, of the deceased;

[Para. (bA) inserted by s. 2 (1) of Act No. 25 of 2015 and comes into operation on 1 January 2016 and applicable in respect of the estate of a person who dies on or after that date in respect of contributions made on or after 1 March 2015.]

***but does not include**-*

(c) in the case of a deceased who was not ordinarily resident in the Republic at the date of his death, any right in immovable property situate outside the Republic;

[Para. (c) substituted by s. 2 (a) of Act No. 65 of 1960.]

(d) any right in movable property physically situate outside the Republic if the deceased was not ordinarily resident in the Republic at the date of his death;

[Para. (d) amended by s. 2 (b) of Act No. 65 of 1960.]

[5] Supra note 2 section 3

(e) any debt not recoverable or right of action not enforceable in the Courts of the Republic if the deceased was not ordinarily resident in the Republic at the date of his death;

[Para. (e) substituted by s. 2 (c) of Act No. 65 of 1960.]

(f) any goodwill, license, patent, design, trade mark, copyright or other similar right not registered or enforceable in the Republic or attaching to any trade, business or profession in the Republic if the deceased was not ordinarily resident in the Republic at the date of his death;

[Para. (f) amended by s. 2 (d) of Act No. 65 of 1960.]

(g) in the case of a deceased who was not ordinarily resident in the Republic at the date of his death-

(i) any stocks or shares held by him in a body corporate which is not a company; and

(ii) any stocks or shares held by him in a company, provided any transfer whereby any change of ownership in such stocks or shares is recorded is not required to be registered in the Republic;

[Para. (g) substituted by s. 2 (e) of Act No. 65 of 1960.]

(h) any rights to any income produced by or proceeds derived from any property referred to in paragraph (e), (f) or (g);

(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.

As can be seen above the act stipulates that all the property of the deceased is to be included in their deceased estate and the only time that this will not be the case is if the deceased was not ordinarily resident in the Republic. Thus the value of the policy is included as property in Tony's estate duty calculations at his death seeing as he was ordinarily resident [the concept will be explained later in this article].

In my view irrespective of whether or not there is a beneficiary nomination on the foreign policy it would still be included as property in Tony's estate. The only time, in terms of the current set of facts, that the policy would not be included in Tony's estate would be if he was not the owner of the policy.

The Act[6] does provide for certain deductions with regards to foreign property, these are contained in section 4(e)[7], which allows a deduction in respect of property situated outside the republic and acquired by the deceased:

(i) Before becoming ordinarily resident in the Republic for the first time (section 4(e)(i); or

(ii) After becoming ordinarily resident in the Republic for the first time and acquired as follows:

- by way of donation from a person (other than a company) not ordinarily resident in the Republic at the date of the donation (section 4(e)(ii)(aa));
- by way of inheritance from a person who at the date of his death was not ordinarily resident in the Republic (section 4(e)(ii)(bb));

(iii) Out of the profits and the proceeds of any property referred to in (i) and (ii) above, proved to the satisfaction of the Commissioner to have been acquired out of such profits or proceeds (section 4(e)(iii)).

In the above set of facts, it is mentioned that Tony is a South African resident, therefore upon his death all of his assets both local and foreign would need to be included in his estate duty calculations, as illustrated above. Seeing as Tony acquired the Namibian life insurance policy once he had already become ordinarily resident in South African the section 4(e) deduction will not be afforded to him. This deduction only applies to property acquired before becoming ordinarily resident in South Africa for the first time or by way of a donation or inheritance from a non-resident after having becoming ordinarily resident in the country.

A natural person can become a resident for income tax purposes as follows:

- By being ordinarily resident in the Republic; or
- Complying with all the requirements in the physical presence test.'[8]

A person becomes ordinarily resident if they consider South Africa their home and the place that they would return to from their wanderings[9]. There is no Act that defines "ordinary resident" and therefore case precedent needs to be taken cognisance of. The founding case precedent for this concept in South Africa is Cohen v CIR[10]. In the case Cohen together with family relocated

[6] id

[7] id

[8] SARS Interpretation Note 4 (Issue 5) 3 August 2018 – Definition in relation to a natural person – Physical Presence Test page 1

[9] SARS Income Tax Interpretation Note No3 4 February 2002 – Resident: Definition in relation to a natural person – Ordinary Resident

[10] Cohen v CIR 1946 AD 174

to New York for business reasons. He needed to source merchandise there for a South African company, OK Bazaars (1929) Ltd. Cohen had only intended to reside in the US for a few months but never came back to South Africa. Cohen owned immovable and movable assets in South Africa. Whilst living abroad Cohen earned dividends from South African companies. Cohen claimed that these dividends were excluded from South African tax seeing as he was not "ordinarily resident" in the Republic. The court said that whether or not somebody was ordinarily resident in the country is a question of fact and in this particular instance it found that Cohen had not proved that he was not ordinarily resident. The court mentioned that the mere physical presence test alone did not suffice and each case would have to be looked at subjectively.

The physical presence test is defined in the section 1 (1) of the Act[11].

'The requirements refer to the number of days that a natural person must actually be present in South Africa, during a year of assessment and also during the five years of assessment preceding the year of assessment under consideration.

These requirements are that the person must be physically present in the Republic for a period or periods exceeding –

(i) 91 days in aggregate during the year of assessment under consideration;

(ii) 91 days in aggregate during each of the five years of assessment preceding the year of assessment under consideration; and

(iii) 915 days in aggregate during the five preceding years of assessment. A natural person who complies with all the requirements referred to above is a resident of the Republic, for tax purposes, for the year under consideration.'[12]

In terms of the set of facts provided Tony meets both residency tests. He has been in the country for a continuous period of 10 years. Further, he considers South African his permanent home.

Estate Duty Agreement with a foreign jurisdiction

In terms of the above set of facts, Namibia does not have an Estate Duty Agreement with South Africa. When presented with a client that has property in different jurisdictions, it is important to check the Double Taxation Agreement and Estate Duty Agreement, if one is in place. These

[11] Income Tax Act 58 of 1962
[12] Supra note 2

agreements could provide for certain rules that need to be taken account of and could impact the tax payable in the various jurisdictions. SARS has a table of countries they have entered into such agreements with which can be found on their website.

Conclusion

The Namibian life insurance policy will be included as property in Tony's estate duty calculations. Further, it does not qualify as a deduction because Tony acquired it after having become ordinarily resident in the Republic. It is important when providing holistic financial planning to your client that you take note of all of their assets, both local and abroad, and to also obtain as much information about them as possible…like exactly when it was acquired. As can be seen in the case study provided the assets can have a huge impact on costs at death.

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Pitfalls in the Wording of Certain Clauses and Conditions in Wills

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Introduction

The Dutch writer and philosopher Hugo de Groot defined a last will as being a declaration of what a person wishes to have happened to his property after his death.[1]

A will is therefore one of the most important documents a person is ever likely to sign and as such, the importance of a correctly drafted and valid will never be disregarded by any person who advises a client on their estate and estate planning. The will is in effect the blue print of the estate plan, which sets the estate plan in process at death.

In this regard, the fact that there are no prescribed requirements for advisors in respect of the drafting of wills for clients is concerning and this was discussed in the Supreme Court of Appeal in *Raubenheimer v Raubenheimer* [2] expressed its concerns as follows:

"It is a never-ending source of amazement that so many people rely on untrained advisors when preparing their will … This is by no means a recent phenomenon. Some 60 years ago, in Ex parte Kock NO, a high court decried the regularity with which the courts were being approached to construe badly drafting wills, before urging intending testators to consult only persons who are suitably trained in the drafting and execution of wills. Despite this, the courts continue all too often to be called on to deal with disputed wills which are the product of shoddy drafting or incompetent advice."[3]

In this article I will identify, analyse and discuss some of the pitfalls that occur in the drafting of wills as well as provide the possible solutions thereto.

Content of wills

A South African testator who is 16 years or older may execute a will, unless at the time of drafting the Will they are mentally incapable of appreciating the nature of the process. The Testator has freedom of testation however it may be limited in specific circumstance. A Testator may stipulate in his or her will whatever he or she wishes, provided that it is not illegal, immoral or against public policy. [4]As a result, the contents of wills may vary greatly. The main provisions in a will are those which dispose of the property of the testator to his beneficiaries, who are the persons who are

[1] Wills and Trusts, W.M. Van der Westhuizen at A1.1
[2] 2012 5 SA 290 (SCA)
[3] Supra note 1
[4] Barclays Bank DC & O NO v Anderson 1959 2 SA 478 (T)

entitled to benefits in terms of a will and could be a legatee or an heir. [5] Wills, however, are not always so simply worded, they may contain provisions of a more complex nature, for example, the testator's interest disposed of in the property may be:

- less than ownership, such as a usufruct;
- a resolutive ownership, such as a fiduciary interest; or
- a suspensive or contingent interest, such as a fideicommissary interest.

The effect of these testamentary devices is that the same thing may be given to more than one person, either concurrently or alternatively or successively. In order to appreciate the effect of these "comprehensive and elastic provisions of our law"[6], it is necessary to know the difference between inheritance and legacy, between ownership and usufruct, and between vested, future and conditional interests. Some of these provisions will be briefly discussed and examined below.

Inheritance and legacy

There is a particularly important distinction to be made between legacies and inheritances. This distinction plays an important role in the final distribution of an estate. A Legacy is a specific sum of money or asset which a testator bequeaths to a person known as a legatee. A Legacy of a particular type is a pre-legacy which, as its name implies, is to be paid prior to any other legacy. [7] On the other hand, an heir is a person who succeeds to the whole or part of the deceased's estate. [8] The benefit that an heir receives is known as an inheritance. The importance lies in the difference in timing of the distribution of the estate. The estate of a deceased person is distributed by the executor by first paying the debts, then handing over the pre-legacies and legacies, and finally giving the balance to the heir or heirs. [9]

Ownership and Usufruct

Ownership

The right to *dominium* in the property vests in the heir on the death of the testator and, following delivery of the asset, he is the owner.

For example, Peter bequeaths his farm to his son Paul

[5] M Botha *et al*, The South African Financial Planning Handbook at 825 (2018).
[6] Estate Kemp v McDonald's Trustee 1915 AD 491
[7] Taylor v The Master 1980 4 SA 414 (T)
[8] M Botha *et al*, The South African Financial Planning Handbook at 825 (2018)
[9] Meyerowitz par 18.2

Usufruct

It enabled the holder (usufructuary) to use certain property (the usufructuary property) belonging/bequeathed to someone else (the bare *dominium* owner) and to enjoy the fruits thereof subject thereto that the substance of the property be maintained. It may be granted for life or for a specified time or until the happening of a specific event. Following the termination of the usufruct the usufructuary property must be restored to the owner (the bare *dominium* owner). For example, Peter bequeaths his farm to his son Paul, subject to the life usufruct therein in favour of his wife Petro.

Vested, conditional and future interests

An interest or benefit under a will may, on the death of the testator, either vest in the beneficiary immediately, or be contingent upon the fulfilment of some condition. If vested, it may be enjoyable presently, or in the future only.

Vested interests

A vested interest refers to an inheritance right which has become unconditionally fixed and established in the beneficiary, with the result that it forms an asset in the beneficiary's estate. It may be disposed of by him or her *inter vivos* or *mortis causa*, and it is normally transmissible to the beneficiary's heirs upon his death (unless the right is purely personal to the beneficiary, such as a usufruct).

The terms *dies cedit* and *dies venit* are very important when dealing with the vesting of rights.

- The phrase used to indicate that a right that has vested is *dies cedit*, which indicates the day or time has come when the right is due or owing.
- Another phrase, *dies venit*, denotes that the time for enjoyment of the thing has arrived; that is to say, that the possession and use of the thing may be claimed

If the right has vested, but its enjoyment is postponed to the future, there is *dies cedit* but not *dies venit*. The time for enjoyment can, of course, arrive only after or simultaneously with vesting. When it does arrive, there is both *dies cedit* and *dies venit*. [10]

[10] Meyerowitz par A 54

Conditional interests

The question of whether, on the death of the testator, an interest under a will is conditional or vested, or vested but not immediately enjoyable, depends entirely on the intention of the testator. This intention is gathered from the language of the will. A testator may postpone *dies cedit* or *dies venit*, or both, by means of conditions or time clauses (terms), and may make a specific benefit dependent on a condition, or may link it to a term or period of time.

When a testator leaves an interest subject to a condition. A condition is a provision that, on the occurrence or non-occurrence of some uncertain future event, a right shall either be conferred or be discharged. There must be uncertainty as to the event, either because it may never happen, or because, although it must happen, it may not happen before some other specified event, such as the death of a particular person, takes place. For example, the testator may leave his farm to his son "if he attains the age of 21."

The most common form of condition found in wills is "if A survives B" (B being some specified or determinable person). The effect of an interest being left conditionally is that it vests, *dies cedit*, only when the condition has been fulfilled. Prior to the fulfilment of the condition, there has been no *dies cedit* (or *dies venit*), and the beneficiary acquires merely a contingent right to the benefit. Suppose, then, that the testator leaves "his farm to his son, if and when he attains the age of 21." Upon the death of the testator, and if the son is alive but under twenty-one, he acquires no vested interest. Consequently, if he dies before reaching that age, nothing is transmissible to his heirs. If, however, he attains the age of 21, *dies cedit*, and the legacy thereupon, vests in him. The same principles are applicable where a testator bequeaths his farm "to his brother and upon his death after the testator, to his sister." His sister acquires a vested interest only if she survives both the testator and his brother.

The conditions mentioned above are suspensive, meaning that the vesting is suspended until an uncertain future event occurs.

A resolutive condition may be attached to a bequest: for example, where a testator bequeaths his farm to his brother John "provided that John's son James, continue to farm on the farm with him." In such a case, the farm vests in the brother upon the testator's death, but not absolutely, for his lifetime. With a resolutive condition, the vesting takes place upon the death of the testator

but falls away at the occurrence of an uncertain future event. [11] On the fulfilment of the resolutive condition, a divesting takes place.

Therefore, there is a distinction, between suspensive and resolutive conditions, with regard to their influence on *dies cedit* and *dies venit*. There is also a distinction between suspensive and resolutive time clauses with regard to their influence on *dies cedit* and *dies venit*.

- **Suspensive conditions:** The right does not vest in the beneficiary until the condition is fulfilled. For example, Peter bequeaths his farm to his son Paul, provided that he pays the amount of R 1 000 000 into his estate within 12 months after his death. If Paul does not pay the bequest price within 12 months into the estate, he will never obtain a right to the farm and it will form part of the residue of Peter's estate. If, however, he pays the bequest price within 12 months, *dies cedit*, and the farm thereupon vests in him. [12]
- **Resolutive conditions**: The bequest terminates on the fulfilment of the condition. For example, Peter bequeaths his farm to his wife Petro subject to the condition that if Petro remarries, the farm will devolve upon his son Paul. Thus Petro has a vested right to the farm until fulfilment of the condition. If Petro remarries divesting takes place and the farm will vest in Paul. However, if Petro never remarries during her lifetime, divesting will not take place and the farm is transmissible to her heirs.

Should the testator fail to appoint a further beneficiary on the condition being fulfilled, the resolutive condition is considered a *nudum praeceptum* and will be disregarded.[13] In other words, the condition is of no effect, and the beneficiary will receive the bequest free from any prohibitions. For example, Peter bequeaths his farm to his wife Petro subject to the condition that she never remarries. Because he failed to appoint a further beneficiary on the condition being fulfilled (the farm must go to his son) the condition is considered a *nudum praeceptum* and will be disregarded.

Conditions considered to be impossible to carry out, illegal or immoral will be taken *as pro non scripto* ("as not written) these conditions will be invalid.

[11] M Botha *et al*, The South African Financial Planning Handbook at 830 (2018)
[12] Meyerowitz par 18.7
[13] Wills and Trusts, W.M. Van der Westhuizen at A55

Future interests

The nature of an interest which is vested but not enjoyable, as opposed to one which is both vested and enjoyable, is well illustrated in case of a legacy by the testator of "a sum of money to his son, payable to him attaining the age of 30 years." In such a case, the legacy is generally not conditional upon the son attaining the age of 30, but the enjoyment of it merely is postponed. It follows that, on the death of the testator if the son is alive, *dies cedit* occurs, and the legacy vests in him, but *dies venit* only occurs when he reaches the age of thirty. If the son dies before reaching the age of thirty, his right to the legacy passes to his heirs.

Modus

Modus can be defined as a bequest in terms of which a testator can impose on the legatee or heir the instruction that the legacy be used for a specific purpose or duty of doing something which restricts or diminishes the extent of the legacy. [14] If the beneficiary accepts the bequest subject to a *modus* an obligation comes into existence which he is compelled to fulfil. The purpose of the *modus* can benefit the beneficiary, a third party or be impersonal. In the case of *modus*, the legatee has a vested right on the death of the testator. In few of the fact that the beneficiary under a *modus* has a personal right against the legatee on whom the duty rests in terms of the *modus*, the beneficiary can enforce his right by action in law. [15]

For example, Peter bequeaths his farm to his son Paul, subject to the obligation that should his son Paul stop farming the said farm, his son must pay half of the rental income of the farm to his sister Jane or her issue *per stripes.* Should Paul sell the said farm, he shall be entitled to 50 percent of the proceeds of the sale and the balance thereof is to be paid to his sister Jane.

Collation

Collation (*collatio bonorum*) is an obligation imposed by law on all beneficiaries in a will, if they are descendants of the testator who wish to share as heirs in the deceased's estate, either by will or on intestacy. The obligation is to account to the estate for any gifts or advances received by them from the deceased, or debts incurred to him, during his lifetime.

Collation is effected by adding to the inheritance the amount due by each heir. The new total is then divided among all the heirs. For example, Jane leaves her estate to her daughters Jenny

[14] Jewish Colonial Trust Ltd v Estate Nathan 1940 AD 163 - 177
[15] Wills and Trusts, W.M. Van der Westhuizen at A60

and Jill. Jenny received a wedding gift worth R60 000 from her mother during her lifetime. The distributable amount of Jane's estate is R300 000. The gift Jenny received is added to the R300 000. An amount of R360 000 is then divided between Jenny and Jill (R360 000/2 = R180 000). Jill will receive R180 000 and Jenny the balance of R120 000 (R300 000 – R180 000). An heir cannot, as long as he refuses to collate, enforce legal remedies to claim his share of the inheritance.

The basis of collation is that a parent is presumed to have intended that there should be equality in the distribution of his estate among his children. [16]

The only persons liable to collate are descendants who are heirs on intestacy or beneficiaries under a deceased's will. [17]

A grandchild, whose father is alive, and who is a beneficiary under his grandfather's will, need not collate. Should their father be deceased and the grandchildren succeed as representatives *per stripes* of the deceased father, then they are liable to bring into collation those advances received by their father from their grandfather. [18]

Collation applies only to heirs who have adiated (accepted the benefit/inheritance). If an inheritance is repudiated (rejected the benefit/inheritance), the heirs who receive the inheritance by accrual will be required to collate what the repudiating heir would have had to collate. Legatees and pre-legatees are not liable to collate unless the will provides to the contrary.

Among the classes of property which must be collated is property which have been given to a descendant as a portion of his inheritance;

- to start him in trade or business;
- as a dowry or marriage gift; or
- as a gift of a substantial nature resulting in inequitable treatment so far as the other children are concerned.

A descendant is expected to collate debts due by him, to the deceased, whether arising from contract, delict or any other source. This is the case even if the debt has prescribed by lapse of

[16] Wills and Trusts, W.M. Van der Westhuizen at 71.2
[17] Supra note 13
[18] Estate van Noorden 1916 AD 175 187-188

time, been extinguished under the provisions of the Agricultural Credit Act, or been discharged by the insolvency and the subsequent rehabilitation of the descendant. [19]

Any amount which is to be collated does not form part of the assets of the estate and, therefore, does not increase the balance for distribution to the heirs as reflected in the liquidation account. It is dealt with only in the distribution account. [20]

It is imported to note that should the testator, therefore, intend to relieve any of his descendant beneficiaries from the obligation to collate, he should clearly express this intention in his will.

Conclusion

Wills have been an important facet, not only in law but also in the lives of people for many centuries. In order for the executor to effectively distribute the assets as provided for in the will, the testator's intention as expressed therein must first be determined. The intention of the testator is to be ascertained from the language used in the will and even if the intention as determined produces results that are unfair, unreasonable or even ludicrous they are to be accepted and will not easily be overruled or changed by the court. In order for the wishes of a testator to be correctly carried out, there are several basic requirements preceding the drafting of a will.

One of the most important requirements is that the drafter must have the necessary knowledge, skill and experience in testamentary law to formulate stipulations and conditions that are legally binding and executable. It is important for drafters of wills to realise that they can never only become scribes of testators because they, the advisor, are supposed to have the knowledge and skills to know and distinguish, which of the wishes of lay testators are practicable in law and which are not. This can be a daunting task especially when keeping in mind the remarks of the Supreme Court of Appeal in *Raubenheimer v Raubenheimer*. [21]

[19] Estate van Noorden 1916 AD 175 186
[20] Abraham NO v Els 1964 2 SA 215 (D) 219
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Trustees and The Power to Delegate Their Duties

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Introduction

An ongoing debate and one that has resulted in various court cases is: Can trustees delegate their powers and if so, what powers and to whom.

All Trustees have the responsibility to ensure that the Trust functions properly to the benefit of the beneficiaries. The powers of a trustee are derived from the trust deed or clauses that are incorporated in a Will. It is important to know that should those documents not allow for a specific power to trustees then it is probably because the founder or testator did not intend for the trustees to have such power.[1] Should a trustee that does not have a particular power, act in respect of such a power, it would be invalid, unless an application is made to the High Court to amend the trust document.[2] The Trustee derives its powers from the trust deed and no Trustee is allowed to formally act on behalf of the trust until he/she has been formally appointed as Trustee by the Master of the High Court[3], when a letter of Authority has been provided. Any action subsequent to such an appointment is void and cannot be ratified.

One clause in particular that is often found in a trust deed of an *inter vivos* trust that is wide, vague and open to interpretation is:
"A Trustee shall be entitled to appoint another person to act as his alternate during his temporary absence or temporary unavailability to act as Trustee."

The ability to delegate powers is also restricted by virtue of the distinction that should be drawn between a delegation of powers from one trustee to another of the same trust and delegation of power by a trustee to another individual who is not a trustee of the same trust.[4]

Delegation of Powers to a Person who is not a Trustee of the same trust

The case of Hoosen NO & others v Deedat & others 1999 4 All 139 (A) dealt with the question of whether a trustee could delegate his powers through a power of attorney to a non-trustee.

[1] DM Davis, C Beneke, RD Jooste Estate Planning 5.7 January 2019.
[2] Section 13 of the Trust Property Control Act 57 of 1988.
[3] Section 6 of the Trust Property Control act 57 of 1988
[4] W Geach J Yeats Trusts Law and Practice 83

The facts of the case were as follows:

- The third respondent, Mr. AH Deedat suffered a stroke that left him paralysed and unable to speak. This disability precluded him from attending meetings of the trustees and performing his duties as trustee.
- Mr. AH Deedat granted a special power of attorney to the first respondent, Y Deedat (his daughter-in-law), who was not a trustee of the said trust, to represent him at trust meetings. He was found to be of sound mind at the time.
- The power of attorney gave the first respondent the right to act on behalf of the third respondent for the express purpose of voting on his behalf as she may "deem fit" as long as it was not against the aims, objects and conditions as contained in the constitution of the trust deed and to sign all documents as required.
- The court *a quo* ruled that the delegation by the third respondent of his duties by means of a power of attorney was valid. The appellants appealed against the ruling.
- The issue on which the Supreme Court of Appeal had to decide on - if the third respondent was entitled in law to delegate his duties in terms of the power of attorney.
- The Supreme Court of Appeal overturned the ruling of the court *a quo* and ruled that the trust deed had no express provision for the delegation by any individual trustee of any of his rights, duties and powers but that all trustees had to act jointly.
- The only provision in the trust deed that was found was largely administrative and did not relate to any area where the exercise of discretion was called for by the trustees in carrying out their duties of management and control.
- The Court of Appeal also further stated that the power of attorney seeks to transfer to the first respondent all the duties and rights of the third respondent. This amounts to a delegation of the third respondent's judgement, discretion and functions to a non-trustee which constitutes a temporary abdication of powers.

A trustee who was chosen by virtue of some special quality or set of skills cannot delegate their powers to anyone else.[5]

In view of the above it is clear that a trustee of a trust can only delegate his discretion, judgement and functions to a co-trustee which is a matter of fact and not one of law.

[5] RP Pace, WM van der Westhuizen Wills and Administration of Estate. 16.1

Delegation of Power to a Trustee of the same trust

The most practical approach when drafting a trust deed is to give the widest powers possible and to determine that trustees must act jointly unless the deed provide otherwise. Should they fail to do so in entering into an agreement then the agreement is invalid and unenforceable.[6]

A trustee only has the authority to act once duly authorised in writing by the Master of the High Court.[7] The trustees, for practical reasons and for the trust to function efficiently, may appoint an administrative trustee to whom they delegate some of their functions, such as the everyday administration of the trust or to consult with experts regarding the trust. The trustees however remain responsible for trust decisions and cannot delegate their responsibilities.[8] It is also important to note that the majority of trustees in office may form a quorum internally at a trustee meeting, but it is not the votes that binds the trust, but the resolution signed by the trustees.[9]

A distinction is made between a delegation of powers[10] and an abdication of powers.[11] Walter Geach and Jeremy Yeats[12] are of the opinion that *"a trustee can only delegate powers to another if that other person is properly authorised by the Master to act as trustee."*

In a recent court case dealing with the delegation of powers, Van Wyk v Daberas Adventures CC [2018] 40030 NCK a full bench of the Northern Cape High Court set aside the decision that a trustee lacked *locus standi* to enter into litigation because all the trustees did not take part in the decision to institute litigation.

The facts of the case were as follows:

- In the court a quo the appellant Mariana van Wyk in her capacity as the delegated trustee, based on a unanimous trustees decision of the Chris van Wyk Trust had brought an application against the respondent to obtain an order that the respondent vacates the property of the trust and remove certain structures set up by the respondent.
- The respondent raised the argument that the trustee lacked *locus standi.* The court *a quo* dismissed the application and held that the resolution authorising the appellant to bring the

[6] RP Pace, WM van der Westhuizen Wills and Administration of Estates Nov 2018 16.1
[7] Section 6(1) of the Trust Property Control Act.
[8] Ibid 3
[9] Davis, Beneke,Jooste 5.7
[10] The appointment of another for whose acts one will be responsible to act on one's behalf.
[11] The appointment of another to act instead of oneself, so as to relieve oneself from responsibility.
[12] W Geach, J YeatsTrusts Law and Practice 83

application was invalid as the decision to adopt the resolution was done without the vote of Mr BC Van Wyk, a joint trustee, which was a requirement in terms of the trust deed. The court further stated that the trustees had not been entitled to delegate the power to implement the resolution to bring the application as it was not provided for in the trust deed.

- The trust deed provided that Mr BC Van Wyk, until his death, had to be a part of any majority decision made on behalf of the trust, and had to be present at the trustees meetings in order for the said meetings to be a *quorum*. It must be noted that at the time of this application Mnr Van Wyk had ceased to be a trustee due to the fact that his estate had been declared insolvent.
- The Court of Appeal found that the respondent's argument that Mr van Wyk had to be present and part of all decisions made until his death, would incapacitate the trust and lead to an absurd result.
- The Court of Appeal further found that this particular clause in the trust deed was clearly to apply only to a decision reached by a majority vote and not to a unanimous votes taken by all the serving trustees.
- Finally, the Court of Appeal, in dealing with the delegation of power, to institute legal action, stated that the absence of an express provision in a trust deed for the delegation of such decisions in a specific case will not render such a delegation invalid, and even less so the delegation of implementation of the decision by the trustees in office taken unanimously, provided that such action is not expressly or impliedly prohibited by the trust deed.

It is important to note the distinction between the power to take part in decision making on the one hand and the power to implement such decisions on the other hand, which may be delegated to non-trustees.[13]

Conclusion

Lessons to be learned from the above discussion and court cases:

- When there is a consideration of becoming a trustee of an *inter vivos* trust it is extremely important to understand, the contents of the trust deed as well as what the exact duties and powers of trustees entails. One must understand what the implications are should one of the trustees be authorised to act on behalf of all the trustees and if the power of delegation is indeed one that is supported by the trust document.

[13] Hoosen and Ohters v Deedat and Others

- When drafting trust deeds, it is also vital to keep away from the "template" trust document and rather ensure that each trust deed is specifically created for individual client's needs. Steer away from vague clauses but rather stipulate exactly what powers trustees may delegate and to whom so that there are no uncertainties or misinterpretations. It is important to remember that a trustee cannot delegate his discretion, duties and responsibilities to a person who is not a trustee of that same trust.
- A further lesson to be learned from the above court cases is that, authorisation to do business with a trust must always be verified by referring to the trust deed or Will and in the case of a power of attorney being used, that same is allowed and that the resolutions are signed correctly.[14]

[14] Trusts and Property transfers – Dangerous ground Schoeman Inc 9 July 2013

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A Sequence of Events - A Practical discussion of the Life Insurance Contract

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Introduction

One might relate the law which regulates the relationships between parties in an insurance contract to Oscar Wilde's definition of "truth" (*The Importance of Being Ernest (1895) Act 1*), that it is as a subject "rarely pure and never simple".[1] In South African law, the emphasis is placed on the rights and duties of the contracting parties. In a traditional insurance contract, the agreement will regulate the relationship between two parties, namely the insured (life assured) and the insurer (the insurance company). Life insurance contracts have however developed over time to also create certain rights for third parties, namely beneficiaries.

This article will explore the rights of the contracting party and the beneficiary by briefly looking at the traditional insurance contract (a life insurance contract with no beneficiary nomination) and more in depth the modern day insurance contract (a life insurance contract with a beneficiary nomination, also known as a "third-party contract").

The Insurance Contract

Firstly, we need to understand the structure of the life insurance contact. A "life policy" is defined in the Long-term Insurance Act[2] as a contract in terms of which a person, in return for a premium, undertake to provide policy benefits upon, and exclusively as a result of a life event (such as death), or to pay an annuity for a period, and it includes a reinsurance policy in respect of such a contract.[3]

Secondly, we must distinguish between the traditional insurance contract and the modern day insurance contract. The traditional insurance contracts finds its origin in the Roman-Dutch law[4] and the law of contract.[5] It is in essence a contract between an insurer and an insured, whereby the insurer undertakes in return for the payment of a price or premium to render to the insured a sum of money, or its equivalent, on the happening of a specified uncertain event in which the insured has some interest. [6] In terms of the traditional insurance contract there is no beneficiary

[1] Alistair Smith: "The Protection of Insurance Policies from Insolvency under section 63 of the Long Term Insurance Act 52 of 1998' (2000) 12 SA Merc LJ p 94
[2] 52 of 1998
[3] Section 1(1)
[4] Elzettte Mulller – The treatment of life insurance policies in deceased estates with a perspective on calculation of estate duty 2006 (96) THRHR at paragraph 2.1
[5] M Botha, L Rossini, W Geach, B Goodall and L Du Preez, South African Financial Planning Handbook (2016) at page 224
[6] Lake and Others NO v Reinsurance Corporation Ltd and Others 1967 (3) SA 124 (W)

nomination. The contracting party, who is also the life assured, acquires a vested right to claim the policy proceeds on date of the conclusion of the agreement.[7]

The modern day insurance contact includes a third party, namely the beneficiary. A beneficiary nomination is generally construed as a contract in favour of a third party, which is also known as a *stipulatio alteri.*[8] In short a *stiulatio alteri* is a contract between two persons, namely the insurance company (the *promittens*) and the contracting party (the *stipulans*), that is designed to enable a third party (the beneficiary), to contract with the insurance company. The mere conferring of a benefit is however not enough. In Total South Africa (Pty) Ltd v Bekker No[9] it was found that the third party (the beneficiary) can only become a party to the contract once he has adopted the benefit, in other words accepted the benefit.

The "conferred benefit" in other words is the agreed offer that would be made by the insurance company to the beneficiary, with the intention that on acceptance of the offer by the beneficiary, a contract will be established between the beneficiary and the insurance company. [10] Therefore, to complete the contract the beneficiary is required to either accept the nomination (before the benefit is due) or the benefit (after the benefit becomes payable).[11] The beneficiary falls away should the beneficiary reject either nomination or the benefit.

Thirdly it is important to note that the life insured is only the object of the insurance on whose life the contract is based. The life insured has no right and no obligations under the contacts.[12]

Example 1:

John is the contracting party of a life assurance policy on Peter's life. Peter dies. On conclusion of the agreement, John acquired a vested right to claim the policy proceeds. There is therefore no need for John to accept the policy proceed as he had already, as the contracting party, acquired a vested right to the policy proceeds when he entered into agreement with the insurance company.

[7] Supra 4
[8] M Botha, L Rossini, W Geach, B Goodall and L Du Preez, South African Financial Planning Handbook (2016) at page 232
[9] 1992 (1) SA 617 (A)
[10] Supra 4
[11] Supra 4
[12] M Botha, L Rossini, W Geach, B Goodall and L Du Preez, South African Financial Planning Handbook (2016) at page 225

Example 2:

John is the contracting party of a life assurance policy in his own life with Peter as the beneficiary. John dies. The insurance **company** will offer the policy proceeds to Peter and only once Peter has informed the insurance company of his acceptance of the benefit, will he require a vested right to the policy proceeds.

The Rights of Contracting Party and the Beneficiary (Revocable insurance contracts)

1. Nomination of a beneficiary (Right or a mere *Spes*)

The nomination of a third party as a beneficiary can either be revocable (there is a "no rights" clause) or irrevocable (there is no "no rights" clause). The right to revoke usually vests with the contracting party. Where a beneficiary nomination is revocable, the contracting party reserves the right to amend the nomination without the insurance company or the beneficiary's consent.

On the other hand, an irrevocable nomination cannot be unilaterally changed by the contracting party. The contracting party will need the consent of the insurance company to amend the beneficiary nomination. However, once the beneficiary has accepted the benefit in an insurance contract containing an irrevocable nomination, then he too has become a party to the insurance contract and his consent will also be required to change the beneficiary nomination. Acceptance may take place before or after death of the insured, where the beneficiary nomination is irrevocable. Therefore, with an irrevocable insurance contract, once the beneficiary has accepted the benefit, even before the benefit is due, the contracting party would require the beneficiary's consent to change the beneficiary nomination.

However, the modern day life insurance contracts usually contain a so called "no rights" clause, which in short prescribes that the beneficiary has no rights during the lifetime of the life insured. [13] By including the "no rights" clause in the contract, the contracting party reserves the right to unilaterally revoke the right to nominate a beneficiary. Therefore, with a modern day insurance contact, prior to acceptance of the benefits, the beneficiary only has a *spes* (expectation).[14] The beneficiary has no right to accept, but a mere competency.[15] Should the beneficiary elect

[13] Warricker and Anohter NNO v Liberty Life Association of Africa Ltd 2003 (6) SA 272 (W)
[14] Supra 4
[15] Wessels v De Jager 2000 4 SA 924 (SCA) 928C-D

not to accept the rights under the contract once it becomes due, then the proceeds must be paid over to the contracting party.[16]

It is furthermore important to note the policy benefits payable to a nominated beneficiary, who duly accepted such benefits, shall not pass to the beneficiary through the estate of the owner of the policy, but will vest in die beneficiary directly.[17]

2. When does acceptance take place

To complete the third-party contract, the beneficiary must accept the benefit offered to him by the insurance company. [18] Acceptance can be either express or tacitly. [19] For acceptance to be valid the insurance company must be informed by the beneficiary of his/her acceptance.

The acceptance should be made while it is open for him or her to do so in terms of the insurance contract, and if a specific time limit is not provided for in the contract, the acceptance should be made within a reasonable time.[20] If there is no specific time clause provided in the contract, then the acceptance should be made within a reasonable time.[21]

Therefore, unless the beneficiary has accepted, the contracting party may alter or cancel their contract at will so as to change or revoke the nomination of the beneficiary.[22] If the beneficiary accepts, then an obligation is forged between the beneficiary and the insurance company with the result that the beneficiary acquires a direct right against the insurance company.[23]

Example 1:

John acquired a life assurance policy on his life with Sam as the nominated beneficiary. John dies and a Sam accepts the policy benefits by informing the insurer in writing of his acceptance of the policy benefits. Sam, prior to John's death, merely had an expectation. On John's death he acquires the right to accept the benefit of the nomination. It was only when Sam informed the insurer of his acceptance, after John's death, did Sam acquire a vested right against the insurance company to receive the policy proceeds.

[16] Supra 4
[17] Supra 13
[18] M Botha, L Rossini, W Geach, B Goodall and L Du Preez, South African Financial Planning Handbook (2016) at page 426
[19] Dykman v Die Meester 2000 (1) SA 896 (O) 902D
[20] Supra 4
[21] Mutual Life Insurance Co of New York v Hotz 1911 AD 556 567
[22] Hofer v Kevitt NO 1998 (1) SA 382 (SCA) 387
[23] McCullogh v Fernwoord Estate Ltd 1920 AD 204 206

Example 2:
John is the contracting party of a life assurance policy on Peter's life, with Sam as the beneficiary. Peter dies, and before Sam could inform the insurance company of his acceptance of the policy benefits, John changes the nominated beneficiary to Susan. The policy benefits will, should Susan inform the insurance company of her acceptance of the policy benefits, pay out to Susan. Sam will have no right to the policy benefits.

3. What happens if the beneficiary dies before the life assured?

Prior to acceptance by the beneficiary, the insurance company is only contractually bound to the contracting party to benefit the beneficiary.[24] The beneficiary, as discussed above, has no rights until the insured event (usually death of the insured) has occurred, and the beneficiary has accepted the policy benefit.

In PPS Insurance Company Ltd & Others v Mkhabela[25] it was found that, until the death of the life assured, the beneficiary merely has a *spes* (an expectation) of claiming the benefit of the policy during the lifetime of the life assured. On the death of the life insured the policy benefit becomes open for acceptance by the beneficiary.

Therefore, if a nominated beneficiary predeceases the life assured (contracting party), the executor of the nominated beneficiary's estate will have no right to the policy proceeds. The beneficiary's *spes* (expectation) therefore evaporates on the death of the beneficiary.

Example:
John acquired a life assurance policy on his life with Sam as the nominated beneficiary. Sam dies and John dies thereafter. Sam passed away before John, and he could therefore not accept the policy proceeds. Sam therefore had no vested right to the policy proceeds and therefore his estate has no vested right to the policy proceeds. Sam's so called spes (expectation) fell away on his death. The policy proceeds will therefore be payable to John's estate.

[24] M Botha, L Rossini, W Geach, B Goodall and L Du Preez, South African Financial Planning Handbook (2016) at page 426
[25] (159/2011) [2011] ZASCA 191

4. What happens if the beneficiary rejects the benefit offered to him?

In the event that the beneficiary rejects the nomination or the benefit offered, then the beneficiary falls away and the proceeds is payable to the contracting party.

In Warricker NNO v Liberty Life Association of Africa LTD[26] the approach was endorsed that the right to the policy proceeds falls into the estate of the insured (contracting party) pending acceptance of the nomination by the beneficiary. Thus if the beneficiary rejects the benefit, the policy proceeds vest in the insured's (contacting party) estates.

The contracting party's right to claim the policy proceeds therefore vests in the contracting party on conclusion of the contract, it however only becomes payable upon death of the insured, and on condition that the beneficiary rejects the benefit nomination or the benefit offered to him. The moment of death is therefore nothing more than a time clause, a *dies certus an incertus quando*[27], A time clause can either be resolutive or suspensive. The time clause incorporated in an insurance contract is suspensive and the full operation of the obligations is postponed until the death of the life assured.[28]

Example:

John acquired a life assurance policy on his life with Sam as the nominated beneficiary. John dies thereafter. Sam informs the insurance company that he rejects the offer of the benefit. John was the contracting party and his estate therefore had a vested right to the policy proceeds, subject to Sam acceptance/rejection. Due to Sam's rejection of the benefits, the policy proceeds will vest in John's deceased estate.

5. What happens if the beneficiary dies after the life assured, <u>without accepting the benefit</u>?

Usually if the beneficiary dies after the life assured but before accepting the benefit, his executor may not accept the benefit on behalf of the deceased estate.[29] This is in line with the fact that an ordinary offer expires on the death of the offeror or offeree.[30]

[26] 2003 (6) SA 272 (W)

[27] Elzettte Mulller – The treatment of life insurance policies in deceased estates with a perspective on calculation of estate duty 2006 (96) THRHR at paragraph 2.2.2

[28] Supra 3

[29] PPS Insurance Company Ltd v Mkhabela 2012 (3) SA 292 (SCA)

[30] MFB Reinecke, JP Van Niekerk, OM Nienaber, South African Insurance Law (2013) at par 19.25

One will therefore ask: ***"Why can an offer not be accepted by the executor of the offeree (the deceased beneficiary)?"*** The answer to this question in short is that an offeror (the insurance company in agreement with the contracting party) does not normally contemplate that the contract, concerning the obligation of the payment of the benefit and the claim by the beneficiary, shall come into existence otherwise than between the insurance company and the chosen offeree (the beneficiary) personally.[31] In Levin v Drieprok Properties [32] it was found that it is a cardinal principle of law of contract that a simple contractual offer made to a specific person can be accepted only by that person. The offer can therefore only be accepted by a person (the beneficiary) to whom the offeror (the insurance company in agreement with the contracting party) originally intended to contract with, namely the offeree (the beneficiary).[33]

The matter may well be different if the beneficiary dies after accepting the benefit, as a reasonable expectation of performance has now come to exist, and the contract ought to be enforceable by the executor of the deceased beneficiary against the insurance company.[34]

Therefore, if the beneficiary nomination is revocable, and the beneficiary dies before accepting the benefit, then the executor of the beneficiary may not accept the benefit on behalf of the deceased estate.[35]

Example 1:

John acquired a life assurance policy on his life with Sam as the nominated beneficiary. John dies and Sam dies two weeks thereafter. Sam never informed the insurance company of his intention to accept the policy benefits. The moment John passed away, the policy benefits became amenable for acceptance, however, Sam passed away prior to accepting. Sam did not have a vested right to the policy benefits during John's lifetime, merely a *spes* (expectation). On John's death the policy benefits fell open for acceptance. However, because Sam passed away before he could accept the policy benefits, he had no vested right. The policy proceeds will therefore be payable to the contracting party, which is John's estate.

[31] GB Bradfield (Original text by RH Christie), The Law of Contract in South Africa at par 2.2
[32] 1975 2 SA 397 (A) 407
[33] S Van der Merwe, LF Van Huysteen, MFB Reinecke, GF Lubbe, Kontraktereg Alegemene Beginsels (2003) at page 63
[34] Supra 31
[35] Supra 30

Example 2:

John's Family Trust, an *inter vivos* trust, is the contracting party of a life assurance policy on John's life, with John as the beneficiary. John dies. John died before accepting the policy benefits. The policy benefits will therefor vest in the contracting party, namely John's Family Trust.

A contrary view on this aspect is that "*if the policy proceeds become payable on the death of the policyholder and the beneficiary dies before accepting the benefit, there is nothing preventing the beneficiary's executor from accepting the benefit provided it is done within a reasonable time and that the beneficiary nomination had not previously been revoked*".[36] In my opinion this view does not coincide with the legal principles of "offer" and "acceptance" as discussed above, specifically where the beneficiary nomination is revocable, as most modern day life insurance policies are.

If the beneficiary nomination is irrevocable (which is not the case with most modern life insurance contracts), the executor would be able accept the benefit on behalf of the deceased beneficiary's estate.[37] It must furthermore be mentioned that there is nothing in law preventing the parties in a revocable insurance contract from contractually including a clause which enables an executor of a deceased beneficiary's estate from accepting the policy benefits in the event that beneficiary passes away after the life assured.

Therefore, the executor of a deceased beneficiary's estate (who passed away after the life assured) will only be entitled to accept the benefit if:

- the insurance contract specifically makes provision for the executor of the deceased beneficiary's estate to do so; or
- if the beneficiary nomination is irrevocable.

Conclusion

It is clear that a sequence of events can have a substantial impact as to whom the policy benefits are payable to on the death of the life assured. It is therefore important for advisors to note the

[36] M Botha, L Rossini, W Geach, B Goodall and L Du Preez, South African Financial Planning Handbook (2016) at par 10.8.3.1

[37] MFB Reinecke, JP Van Niekerk, OM Nienaber, South African Insurance Law (2013) at par 19.25

importance in properly structuring a life insurance policy and also take note of the contractual terms and conditions contained in the policy agreement. The incorrect structuring of a life insurance policy can have detrimental effects, in that the policy proceeds might be paid to the person whom the benefit was never intended for.

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Mauritian Trusts – Estate planning tool or not?

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Introduction

South African taxpayers have enjoyed some relief in exchange control limits in the past few years and for some this provided the opportunity to form and invest in offshore trusts. The current Foreign Capital Investment allowance is R10 million per person per year and an additional single discretionary allowance or R1 million per individual per calendar year is also allowed. Trust has been a popular estate planning tool for wealthy South Africans to manage their assets for many years. However, the constant change of the Tax Legislation by the relevant tax authorities' worldwide means that South African tax structures needs to be reviewed on a regular basis. Mauritian trusts have become the new flavour of the month in offshore trust structures, mainly because of the perceived tax benefits for the trust and also because of the privacy rules pertaining to the registration of these trusts. The purpose of this article is to examine the Mauritian Trust in terms of the Mauritian Trust Act of 2001and in particular with regards to its structure, tax benefits and usefulness as an estate planning tool for South African tax residents.

Mauritian Trusts – Structure, Registration requirements, Jurisdiction and Taxation

Trusts in Mauritius are governed by the Trust Act of 2001.[1] A Mauritian trust can only be created by a written trust instrument which must set out its object, intention, duration, beneficiaries or class of beneficiaries, the property transferred or held in trust and also the duties and powers of the trustees.[2] The Mauritian trust does not have to register with the Mauritian authorities and therefor allows for total privacy of the settlor, beneficiaries and the assets in the trust.[3] Anti-money laundering regulations does require the trustees to know the identity of the settlor and the ultimate beneficiaries, but disclosure to third parties is only required in very particular circumstances and must always be accompanied by a court order.

Section 11 of the Trust Act 2001, provides certainty around asset protection to the settlor and beneficiaries. It provides, clarity on when and how a trust may be revoked, when Trust be void or voidable and instances when claims against trust property will be valid or not. For example, Section 11 of the Trust Act 2001 provides that a court shall not, where the Trust is governed by Mauritian Law, recognise the validity of any claim against the trust property under the law of another jurisdiction or enforce the order of a court of another jurisdiction in respect of the

[1] Mauritian Trust Act 14 of 2001
[2] Section 6(1) and (2) of Act 14 of 2001
[3] Section 3(1) of Act 14 of 2001

personal and proprietary consequences of a marriage or the dissolution of a marriage, succession rights or the claim of creditors in insolvency.[4]

The Mauritian trust Act typically allows for different types of trusts, of which the most popular are discretionary trusts and purpose trusts.[5] The discretionary trust allows very wide powers to the trustees, specifically with regards to the power to add or remove beneficiaries, distribute income and/or assets to beneficiaries and the times and amounts of these distributions. These trust are normally formed when the trust deed does not provide for these decisions. This is very much in line with South African trust structures and as with South African trusts, the settlor can provide a letter of wishes to guide the trustees with regards to the administration of the trust and management and vesting of assets. The Trust Act also allows for certain types of purpose trust. A purpose trust is established with a certain purpose in mind and is not for the general benefit of beneficiaries. With a purpose trust, the trust deed must provide clear instructions on how assets will be distributed and when the trust will vest. An enforcer must be appointed to assure that the trustees fulfil the purpose and their obligations. The appointed enforcers cannot be a trustee and must avoid conflict of interests and they may not derive any personal benefit from the trust. Compensation for the enforcer is however allowed.[6]

The settlor of a Mauritian trust has certain options as to which jurisdictional laws must be applicable to the trust. Jurisdiction is established by the wording of the trust deed or the jurisdiction selected by the settlor. The lifetime of a Mauritian trust is limited by the Rules against perpetuity and may not exceed 99 years.[7] The trust deed must specify the duration of the trust but if it does not, then the 99 years limit will apply. The settlor of the trust must be a minimum of 18 years of age, with the required legal capacity to enter into contracts.[8] The settlor may also be a trustee, beneficiary, protector or an enforcer in the trust but may not be the sole beneficiary of a trust which he/she has created.[9] Any legal entity may also be the settlor of a trust and settlors may be residents of Mauritius or a non-resident from any other country.[10]

Section 7 of the Trust act any property may be held by a trust. Subject to the terms of the trust, a trustee may accept property from any person to be added to the trust property. The trust may

[4] Section 11(5) of Act 14 of 2001
[5] Part III – Objects of a trust, Act 14 of 2001
[6] Section 21 of Act 14 of 2001.
[7] Section 9(1) of Act 14 of 2001
[8] Section 8(1) of Act 14 of 2001
[9] Section 8(2) of Act 14 of 2001
[10] Section 8(3) of Act 14 of 2001

even hold property that is situated outside of Mauritius. However, no transfer or disposal of property to a trust shall be valid in respect of:

- Property which is inalienable under the law of Mauritius;
- A leasehold interest of which the unexpired term is less than 18 years;
- Immoveable property in Mauritius where the trust is a non-charitable purpose trust.

A Beneficiary of a Mauritian trust may be a natural person or legal entity. Beneficiaries must however be identifiable by name or by reference to either a specific class of beneficiaries or specified in the trust document by relationship to current or future beneficiaries, for example, future spouses or children.[11] There are certain very specific rules with regards to the trustees in a Mauritian trust. The settlor will appoint the trustees in the trust document and natural persons or corporations may be appointed as trustees. A Natural person that is appointed as a Trustee must have the required legal capacity to enter and execute contracts to be able to act as a trustee of the trust. A corporation may be appointed as trustee if its laws allows for it and a resolution to that effect has been passed by its Board of Directors.[12] A maximum of four trustees are permitted and at least one of the trustees must be a "qualified trustee" as defined in the Act.[13]

A "qualified trustee" is defined as a management company or such other person resident in Mauritius as may be authorised by the Financial Services Commission to provide trusteeship services.[14] The Trustees have a fiduciary duty to act honestly and in good faith with the required prudence and care in the best interest of the trust.[15] The Trust deed may allow for the appointment of a managing trustee who may have the full power to make decisions on behalf of the trust in their sole discretion.[16] The other trustees will not be held liable for the decisions or actions of the managing trustee.[17] The Trust Act furthermore also allows for the appointment of a custodian trustee. A custodian trustee must be a corporation (Body Corporate), partnership or a company, who may hold property, make investments and dispose of trust assets under the direction of the managing trustee. The custodian trustee cannot be held liable for the acting a direction given by the managing trustee, unless they had reason to believe, the direction given

[11] Section 14(1) of Act 14 of 2001
[12] Section 23(1)(a) and (b) of Act 14 of 2001
[13] Section 28(1) of Act 14 of 2001
[14] Section 2 of Act 14 of 2001
[15] Section 37 of Act 14 of 2001
[16] Section 26(1) of Act 14 of 2001
[17] Section 26(2) of Act 14 of 2001

is in contravention of any law, rule or regulation, contrary to the terms of the trust, contrary to sound commercial practice or otherwise objectionable.[18]

The Trust Act of 2001 also allows for the appointment of Protectors in terms of Section 24 of the Act[19]. The Protector provides advice to and supervises the trustees of the trust. Protectors have a fiduciary duty towards the beneficiaries of the trust and has the power to appoint or remove trustees, determine the jurisdiction of the trust, make administrative changes to the trust and may also withhold consent for specified actions of the trustees, either conditionally or unconditionally.[20] The Protector of the Trust must be of sound mind the Protector may also be a settlor, a trustee, a beneficiary, a corporate, company, partnership or a group of natural persons.[21] Where more than one protector is appointed, a majority consent is required for any action, unless the trust deed provides for otherwise.[22] The Settlors and beneficiaries can also give trustees a letter or memorandum of wishes pertaining to the exercise of their functions under the trust deed. Trustees are however not obliged or required to follow the instructions in the letter of wishes.[23]

Mauritian trusts have a very beneficial tax structure and as a general rule, the income of Mauritian Trusts would be subject to income tax at a rate that is specified in the First Schedule to the Mauritius Income Tax Act of 1995.[24] A non-resident trust, is a trust that has been a non-resident settlor, all the appointed beneficiaries throughout the income tax year is non –and the purpose of the trust is conduct completely outside of the jurisdiction of Mauritius, will be completely tax exempt if the trustee elect to file a declaration of non-residence with the Mauritius Revenue Authority during an income tax year.[25] A Distribution made to beneficiaries from a non-resident trust will be treated as dividends and is therefore exempt from any tax in the hands of the beneficiaries.[26] Non-resident trusts must file a Declaration of Non-Residency every year to maintain its tax exempt status. A Resident trust may also benefit from Mauritius double tax treaties.

[18] Section 25 of Act 14 of 2001
[19]Section 24 of Act 14 of 2001
[20] Section 24(3) of Act 14 of 2001
[21] Sections 24(2) and (5) of Act 14 of 2001
[22] Section 24(6) of Act 14 of 2001
[23] Section 27 of Act 14 of 2001
[24] Section 46(1) of Income Tax Act 1995
[25] Section 46(3) of Income Tax Act 1995
[26] Section 46(5) of Income Tax Act 1995

Taxation of Offshore Trusts

When deciding on whether to transfer assets to a foreign trust, a person needs to be very aware of the tax implications of such transfers as well as the tax implication of income or capital received from offshore trusts. An Offshore trust has the label as a tax avoidance tool and as such has been under scrutiny for some time. Recent changes to the way that income, capital and dividends from these trust are taxed, has proven that the South African revenue authorities has a major drive in closing any tax loophole that might exist and this limits the use of offshore trusts as a tax planning tool. When discussing the tax implications of offshore trusts, it is important to also discuss how these trust are funded when they are set up.

Tax implications for the Donor when setting up the trust

Loans from Donors

Typically, an offshore trust is funded by way of a loan to the trust by the taxpayer. The taxpayer could also fund the trust by way of a donation but such donation would attract donations tax at a rate between 20% – 25%, depending on the amount that is donated to the trust. As an example, a loan of R10 million to a trust would mean a R2 million donation tax liability on the donor. As a result of the donations tax implications, offshore trusts were typically funded by way of interest free loans. However due to the transfer pricing provisions, the attribution rules as well as the recent addition of Section 7C to the Income Tax Act, it is very unlikely that interest free loans will be used to fund offshore trust.

Section 7C was introduced to the Income Tax Act, it has addressed the low or no interest loans to trust and/or related companies in the trust by introducing an "official rate of interest" that has to be charged on low or no interest loans by the taxpayer.[27] The taxpayer is therefore obliged to charge interest on the loan that was made to the offshore trust, at the official interest rate, which is currently 7.75% annually[28]. In the event that the taxpayer fails to charge the required interest on the loan, it will be seen as a donation and will therefore attract donations tax. The loan itself will form part of the taxpayer's South African assets and will therefore be subject to estate duty in the event of the death of the taxpayer.

[27] Section 7C of Income Tax Act 58 of 1962
[28] Seventh Schedule to the Income Tax Act 58 of 1962

Donor attribution rules

In terms of Section 7(8) of the South African Income Tax Act[29] income from foreign trust may be attributed to a South African resident who has made a donation, settlement or disposition to a foreign trust. This includes loans that incurs interest at a less than market related rate. If such income would have been included in the income of the foreign trust had it been a resident, it will be deemed as income of the donor. Paragraph 72 of the Eight Schedule of the Income Tax Act[30] deems capital gain, or the amount which would have constituted capital gain, had the trust been a resident, arising in a foreign trust to be taxable in the hands of the resident who has made the donation, settlement or disposition to that foreign trust. The Taxation Laws Amendment Act of 2018[31] has introduced amendments to Section 10B(2)(a) of the Income Tax Act[32] and Paragraph 64B of the Eight Schedule.[33] In terms of these amendments, foreign dividends[34] and/or capital gain from the disposal of equity shares in a foreign company by the foreign trust[35], will still be taxable in the hands of a South African donor, even if these dividends or capital gain would have been exempt if the trust had been a resident.

Tax implications of income and capital received by beneficiaries.

In terms of Section 25B(2A) of the Income Tax Act[36] capital that vests in a South African resident beneficiary of the trust, must be included in the taxable income of that resident if such capital would have been taxable as income of the trust, if that trust has been a resident, the beneficiary had contingent rights to that income, and if such income has not already been subject to tax in South Africa. Paragraph 80(1) of the Eight Schedule to the Income Tax Act[37] determines that where a trust vests an asset in a resident beneficiary, any capital gain must be disregarded in the hands of the trust and must instead be accounted for as capital gain in the hands of the resident beneficiary. Paragraph 80(2) provides that where a trust disposes of an asset and then vests any capital gain in the same tax year in a resident beneficiary, any capital gain must be disregarded in the hands of the trust and must instead be accounted for as capital gain in the hands of the resident beneficiary. Paragraph 80(3) determines that when capital gain vests in later years in a resident beneficiary, then that gain must be taxed in the hands of the resident beneficiary,

[29] Act 58 of 1962
[30] To the Income Tax Act 58 of 1962
[31] Act 23 of 2018
[32] Of the Income Tax Act 58 of 1962
[33] To the Eight Schedule to the Income Tax Act 58 of 1962
[34] Section 10B(2A) Act 58 of 1962
[35] Paragraph 64B, Eight Schedule to Act 58 of 1962
[36] Act 58 of 1962
[37] Act 58 of 1962

provided that gain was made during a year in which the resident beneficiary had a contingent right to the capital of the trust and that the gain has not be taxed in terms of any other provision of the Act.[38] The Taxation Laws Amendment Act of 2018[39] has introduced amendments to Section 10B(2)(a) of the Income Tax Act and Paragraph 64B of the Eight Schedule. In terms of these amendments, foreign dividends[40] and/or capital gains that arise from the disposal of equity shares in a foreign company by the foreign trust[41], will still be taxable in the hands of a South African beneficiary, even if these dividends or capital gains would have been exempt if the trust had been a resident.

Conclusion

Offshore trusts, including Mauritius trusts, is subject to a plethora of tax regulations in South Africa and the offshore trust loses some relevance when the combination of estate duty, donations tax paid on the interest on the loan that is used to set up the trust, is taken into account. This constitutes a significant tax cost and when combining it with the costs of setting up and managing the trust it makes these trusts less attractive as a tax planning tool. Furthermore, if the resident beneficiary is taxed on income or capital received from the trust, the question must be asked as to why set up the offshore trust? Diversifying investment and political risks, avoiding probate or even protecting assets for beneficiaries might be reasons for setting up an offshore trust but it is clear from the above that tax should not be the only reason for doing this.

[38] Paragraph 80(3) of the Eight Schedule to Act 58 of 1962
[39] Taxation Laws Amendment Act 23 of 2018
[40] Section 10B(2A) Act 58 of 1962
[41] Paragraph 64B, Eight Schedule to Act 58 of 1962

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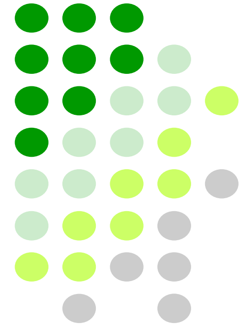


Business Assurance Planning

Share Buy-Back Agreements vs Traditional Buy-and-Sell Agreements

Chantel Strauss CFP®
BCom, LLB, Adv PG Dip in Fin Plan
Legal Adviser Specialist
Personal Finance: Pretoria

1. Introduction

A traditional buy-and-sell agreement is used between shareholders of a company, partners in a partnership or members in a close corporation when a business owner of a company wants to sell his/her interest in a business in the event of death or disability. Normally, the owners of a business, would insure each other's lives with a long term insurance policy and this policy will be used to fund the agreement between them to buy the effected owner's interest from such owner or his/her estate.

Financial planning in South Africa has evolved and as this industry developed so did the products and the advice being provided to clients.

The simplest form of a business is an enterprise owned by one person who has people working for him/ her in the business. This business entity is generally referred to as a sole proprietorship in South Africa. In terms of South African law, we however also have other types of business entities such as partnerships, close corporations and companies.

Just as the world evolved so did businesses and our laws. Plans are made for business owners to assist them in growing their businesses and help them save taxes. Estate planning is done for clients to help them save on expenses and to keep their business interest in their families. For many years trusts have been used as a popular estate planning tool. Clients are sometimes advised to start a business or buy business interests in a trust or even to buy business interests using another company.

One of the advantages of the buy-and-sell agreement, is that in terms of Section 3(3)(a)(iA) of the Estate Duty Act 45 of 1955 ("the EDA"), where a policy is used to fund this form of agreement, this policy proceed may be exempt from estate duty if this policy was structured in terms of the requirements of this section. One of the requirements is that both the life insured and the policy owner (contracting party in respect of the policy) must be co-owners of the business entity that is the subject of the buy-and-sell agreement. This requirement became a problem because, as mentioned above, a popular tool for estate planning was the use of trusts, and clients were advised to sell their assets to trusts. If a trust is a party to this agreement, the trust would nominate a person (usually a trustee) to be the insured life on a policy used to fund a buy-and-sell agreement. Should such trustee die, the above requirement is not met and the policy proceeds will not be exempt from estate duty. Furthermore, besides estate duty, from the 1st of October

2001, when a person (in this instance it will be the trust) disposes of an asset and a capital gain is made on such disposal, income tax must be paid on the taxable capital gain. This tax is known as capital gains tax ("CGT").

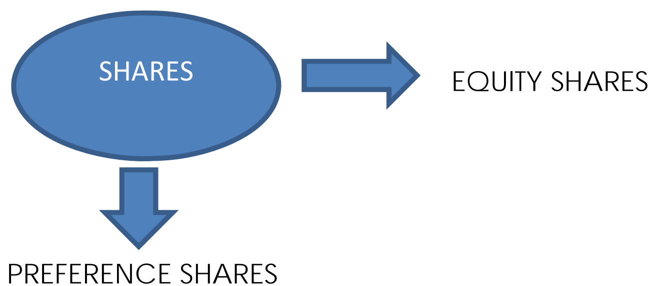
2. Companies in South Africa

A business entity that is commonly used today is a registered company. In terms of the Company Act 71 of 2008 ("the Act") a distinction is made between various types of companies in South Africa. For purposes of this article when referring to a company the term will refer to a private company. In terms of the Act[1], the Memorandum of Incorporation ("the MOI") of a company may contain restrictive conditions as well as requirements for amending such conditions or prohibitions against amending such conditions. A MOI could contain a provision that in the event of the death or disability of a shareholder, the company is obliged to buy back the shares from such effected shareholder or his/her estate.

Share Capital in a company

A distinction is made between the following type of share capital:

1. Preferential Share Capital and
2. Equity Share Capital.



Preference Shares

This is part of the issued share capital of a company. These shareholders enjoy preferential rights when the company declares a dividend or capital distribution when winding up.

[1] Section 15(2)(B) of the Companies Act 2008

Ordinary Shares

This is shares that are not preference shares. Haupt explains it as flows:

Ordinary shares are equity shares. A member's interest in a close corporation is an 'equity share'. Any interest in the capital of a company is a share of that company or in that company."[2]

Section 1 of the Income Tax Act 58 of 1962 defines a share as "*in relation to a company, any unit into which the propriety interest*[3] *in the company is divided*." A shareholder does not own the assets of the company, but they own the right to vote, the right to dividends and the right to **capital on winding up.**

3. Share Buy-Backs

In terms of a share buy-back or share re-acquisition agreement, a company agrees to repurchase of its issued shares from the holder of such shares in the company. The definition of "distribution" in Section 1 of the Act includes the direct or indirect transfer of money or other property of the company to one or more holders of any of the shares in the company as consideration for the acquisition by the company of any of its shares. Accordingly, the re-acquisition by the company of its shares, as a "distribution", must comply with the provisions of section 46 of the Act.

Section 46(1) of the Act prohibits the company to make a proposed distribution, unless

a) *the distribution*
   - *(i) is* pursuant *to an existing legal obligation of the company or a court order, or*
   - *(ii) the distribution is authorized by the board of the company;*

b) *it reasonably appears that the company will satisfy the solvency and liquidity test after* completing *the proposed distribution; and*

c) *the board of the company, by resolution acknowledged, by resolution, that it has applied the solvency and liquidity test, as contemplated in Section 4 of the Act, and reasonably concluded that the company will satisfy the solvency and liquidity test immediately after completing the proposed distribution.*

The re-acquisition by the company of its own shares will pass the solvency and liquidity test, as mentioned above, if immediately after the transaction the company's assets, as fairly valued,

[2] Note on South African Income Tax 2018, 37 Edition, Phillip Haupt pg 258

[3] Propriety interest: means ownership for the benefit of the owner.

equal or exceed the liabilities of the company, as fairly valued; and the company will be able to pay its debts as they become due in the ordinary course of business for a period of 12 months following such re-acquisition.[4]

Before a company may re-acquire its own shares, there are certain requirements in the Act that must be met.[5]

When the board of the company decides to re-acquire shares of the company - such a decision of the board must be approved by way of a ***special resolution*** of the shareholders of such company,

- if any of the shares forming part of the buy-back will be acquired from a director or prescribed officer of the company, or
- any person related to a director or prescribed officer of the company[6].

In terms of the Act[7] if a re-acquisition of shares would result in the company re-acquiring more than 5% of the issued shares of the company (or any particular class thereof) the transaction will be subject to Section 114 and 115 of the Act. In terms of Section 114 of the Act when a company reacquires its own shares the company must retain an independent expert report who meets certain requirements laid down in Section 114(2) of the Act. The person retained must prepare a report to the board concerning the proposed arrangements.

3.1. Solvency and liquidity test: share-buy-back agreements

When the board of the company decide to re-acquire the shares from a shareholder the board of the company must by way of resolution acknowledge that the solvency and liquidity test was applied a\\]nd the company pass the solvency and liquidity test at a particular time, if considering all reasonably foreseeable financial circumstances of the company at that time.[8]

[4] Section 4(1) of the Companies Act
[5] Section 48 of the Companies Act 71 of 2008
[6] Section 48(8)(a) of the Companies Act 71 of 2008
[7] Section 48(8)(b) of the Companies Act 71 of 2008
[8] Section 4(2)(b) of the Companies Act 71 of 2008

3.2. Tax implications of share-buy-back agreements

3.2.1. Dividend tax

The definition of "dividends" in terms of Section 1 of the Income Tax Act ("the ITA") specifically includes the repurchase by a company of its shares, except to the extent that this repurchase results in a reduction of contributed tax capital[9].

"Contributed tax capital" is defined in section 1 of the Income Tax Act and a distinction is made between non-resident and resident (other) companies. From purposes of this article, the focus will be on resident companies. This article will also not deal with. For a company other than a non-resident company, the concept of 'contributed tax capital' can be summarized as follows:[10]

The 'untainted' share capital and share premium (or stated capital) of the company immediately before 1 January 2011 (if any) plus the consideration received by or accrued to the company for the issue of shares on or after that date. The contributed tax capital of a company must further be reduced by as much of it as is transferred on or after 1 January 2011 for the benefit of any person holding a share in such company.

Therefore, when the board of the company decide to repurchase the shares of the company and all the requirements were met as set out in the Companies Act No. 78 of 2008 ("the Act") this transaction will be regarded as a dividend and dividend tax will be payable on the dividend declared.

Example:

Mr. A subscribed for 50 shares in Company X against payment of a subscription price of R100,000. On date of death of Mr. A, the board of the Company X decided to repurchase the 50 shares from the estate of Mr. A for a consideration of R150,000.

The payment of the consideration paid by Company X to repurchase Mr. A's shares in Company X will be treated as follows:

Repayment of contributed tax capital	R100,000
Dividend	R50,000

[9] Paragraph (b)(i) of the definition of dividend in section 1 of the Income Tax Act

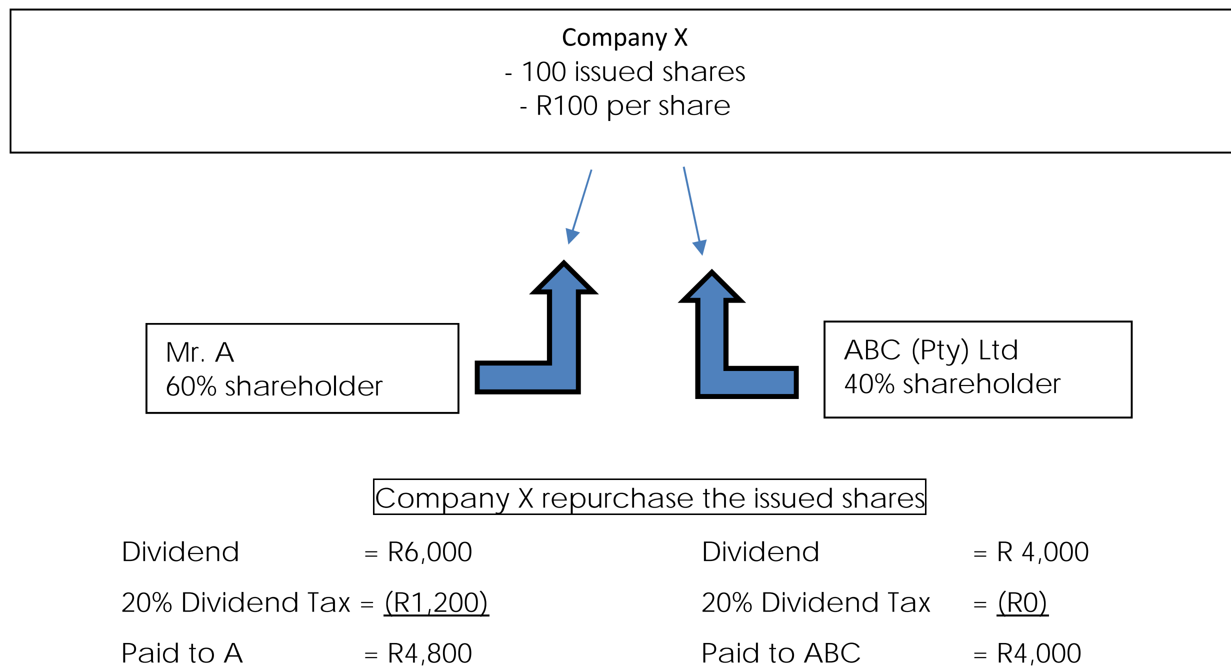
[10] P Haupt, Notes on South African Income Tax, 2019, H & H Publications, p 445; Paragraph (b) of the definition of 'contributed tac capital' in section 1 of the Income Tax Act

In terms of Section 64D of the ITA a dividend is defined, for "Dividend Tax" purposes as:

(i) a 'dividend paid by a South African resident company, or

(ii) a dividend paid by a non-resident company if the share in respect of which that foreign dividend is paid is defined as a 'listed share' in section 1 of the ITA and does not consist of a distribution of an asset in specie.

Section 64F of the ITA applies to dividends paid in cash and dividends credited to the shareholder's loan account[11], and deals with exemptions applicable to dividend tax. When a company that is a South African resident is the beneficial owner in respect of shares in another company and a dividend is declared by the last mentioned company, this dividend will be exempt in terms of section 64F(1)(a) of the ITA for 'Dividend Tax' purposes



Kindly take note of the Anti-Stripping provision in terms of Paragraph 43A of the Eighth Schedule of the ITA. In terms of the provision "where a company disposes of shares in another company and the shares were held by the disposing company as a capital asset, not as trading stock, and the disposing company held a qualifying interest in the company being disposed of whether the qualifying interest[12] was held at the time of the disposal or at any

[11] P Haupt, Notes on South African Income Tax, 2019, H & H Publications, p 461

[12] Qualifying interest is a 'direct interest held by a company in another company, that is at least 50% of the equity shares or voting rights in the other company or 20% of the equity shares or voting rights in the other company, if no other person holds the majority of the equity shares or voting rights in the company or in

time in the period of 18 months before the disposal any exempt, extraordinary dividend must be treated as part of the proceeds from the disposal of the shares[13]. This dividend will be included in the income of the disposing company. This inclusion will be in the same year of assessment of the disposal.

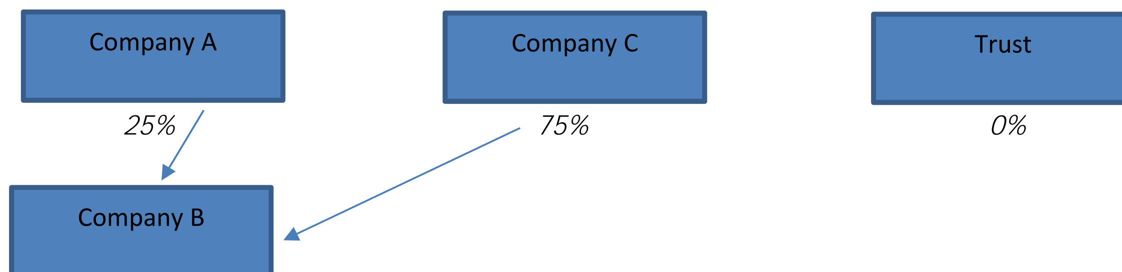
Example:

Haupt[14] provides the following example on dividend stripping:

Company A holds 50% of Company B. There are 100 Company B shares in issue. Both Companies are South African companies. Company A paid R50,000 for these shares in 2004. The shares were acquired as a capital investment. The shares are worth R1 million, and this value has been unchanged for the last two years. The other 50% of the shares in Company B is held by a discretionary trust. These shares cost the trust an amount of R50,000 in 2004. On 30 November 2018, Company A decides to sell half of its interest (25 shares) to a new (incoming) shareholder (Company C) and the trust decided to sell its full interest to the new shareholder.

Prior to the sale, however, Company B declares a dividend of R700,000 to all the shareholders. Company A receives R350,000 (no dividend tax is withheld), and the trust received 80% of R350,000 i.e. R280,000, because dividends of R70,000 is withheld. The new shareholder then purchases half of Company A's holding (i.e. 25 shares) for an amount of R75,000, and all of the trust's shares for an amount of R150,000.

After the transaction, the holding is as follows:



1. What is the tax result?

the case of a listed company, the disposing shareholder holds 10% or more of the equity shares or voting rights in the listed company.

[13] P Haupt, Notes on South African Income Tax, 2019, H & H Publications, p 684

[14] P Haupt, Notes on South African Income Tax, 2019, H & H Publications, p 685 and 686

2. Company A's shareholding in Company B is a 'qualifying interest', because it is not less than 50% of the shares in issue.
3. There is no dividend tax on R350,000 dividend, because the dividend accrues to a company shareholder, and because it is a local dividend, it is also not subject to normal tax – therefore it is an 'exempt dividend' for the purposes of paragraph 43A.
4. The sale of shares to Company C is a disposal of the shares in the hands of Company A.
5. The dividend is received within 18 months before the sale to Company C.
6. The dividend exceeds 15% of the market value of the shares at the date of disposal (R300,000 being the market value) as well as exceeding 15% of the market value of the shares at the beginning of the 18-month period (R1 million being the earlier market value).
7. The dividend is therefore an extraordinary dividend to the extent of R350,000 – 15% of R500,000 = R275,000. The portion that relates to the shares disposed of (the provision uses the words 'in respect of the shares disposed of') is R137,500 (i.e. half of R275,000, because only half of the shares were sold).
8. The result is that R137,500 the dividend is treated as proceeds on the disposal of shares by Company A.
9. Therefore, Company A has a capital gain as follows:
   a. Proceeds on the sale of shares..R 75,000
   b. Tainted dividend..R137,500
   c. Total amount treated as proceeds..R212,500
   d. Cost of shares disposed of R50,000 x 25/50 ....(R 25,000)
   e. Capital gain...R187,500
10. The trust has a capital gain as follows:
    a. Proceeds on the sale of shares..R150,000
    b. Cost of shares disposed of...(R 50,000)
    c. Capital gain...R100,000
11. If the trust retains the capital gain, it pays tax at a rate of 36%[15] of the gain. If the gain is distributed to individuals, the gain is taxed in their hands based on their marginal rates. An individual on the maximum marginal rate, for example, will pay tax at a rate of 18%[16] on the capital gain.

[15] The inclusion rate of 80% x 45% (maximum marginal rate) = 36% effective rate;
[16] The inclusion rate of 40% x 45% (maximum marginal rate) = 18% effective rate;

12. The trust has paid tax of 20% on the dividend, which is different from the 36% or the 18% that would be payable if the dividend stripping had not been entered into, but the result of the dividend strip is that the trust need not distribute the dividend to its shareholders.
13. Paragraph 43A does not apply to a trust, because the dividend that it receives is not exempt from Dividends Tax.

3.2.2. Income Tax

When the board of the company decides to repurchase the shares from a shareholder they must be satisfied that the liquidity and solvency test will be passed. In order for a company to have sufficient funds available, in the event of death, the board can consider taking a life policy on the life of the shareholder. In this case the company will be the owner of the life policy and also be the premium payer on this policy. The company cannot deduct the premiums paid from income tax, this policy is taken out to cover potential capital expenditure and not a loss as contemplated in section 11(w)(ii)(aa) of the ITA.

3.2.3. Capital gains tax

Capital gain tax is actually income tax payable on the taxable capital gain made by the tax payer on the proceeds (or deemed proceeds) from disposal (or deemed disposal) of an asset less the base cost.[17]

When a company repurchases its own shares, from a shareholder in terms of a share buy-back agreement, this will in terms of Paragraph 11(2)(b) of the 8th Schedule of the ITA not be a disposal of assets by a company in respect of the cancellation of a share in the company. A company may not be the owner of its own share and when the company buy back the shares, in terms of a share buy-back agreement, the company will actually cancel shares. The cancellation of a share or member's interest in the company will not be regarded as a disposal of an asset by the company.

In terms of Paragraph 55(1)(e) of the Eighth Schedule of the ITA if a gain arises from the disposal of a long-term life policy the gain can be disregarded if it is a pure risk policy (i.e. the policy has no cash/surrender value). Even if ownership of a pure risk policy is changed, no CGT will be payable.

[17] Premiums and Problems, Edition 119 of July 2019, Page A45;

With regards to the shareholder selling his/her shares back to the company, this will be regarded as a disposal. In terms of Paragraph 35(3)(a) of the 8th Schedule to the ITA, the proceeds from the disposal of an asset must be reduced by any amount included in the gross income of that person. Paragraph (b) of the definition of 'dividend' in Section 1 of the ITA includes any amount paid "as consideration for the acquisition for any share in that company" to the extent that it does not reduce the contributed tax capital of such company. Therefore, the amount that the shareholder receives in respect of a share buy-back, that does no reduce the contributed tax capital of the company, will constitute a dividend and be taxed as a dividend received from the company.

3.2.4. Estate duty

Shares can be held in a natural person, trust or even in another company. Shares held by a natural person, will in terms of Section 3(2) of the Estate Duty Act 45 of 1955 ("the EDA") form part of a person's estate as property. These shares will be included in the estate of the deceased for estate duty purposes. If shares are held by the trustees of a trust this is not the property of a natural person and therefore will not be included in the estate as property. In terms of Section 3(3)(a) of the EDA, deemed property includes the proceeds of all "domestic policies" on the life of a deceased and are thus deemed to form part of his or her property for estate duty purposes[i].

An exemption[18] applies if a policy on the life of a deceased is taken out to fund a buy-and-sell agreement, provided that the following requirements are met:

1. The policy was taken out or acquired by a person who, on the date of the death of the deceased, was a partner of the deceased, or held a share or like interest in a company in which the deceased, on that date, held a share or like interest; and
2. The policy was taken out or acquired with the purpose of acquiring the deceased's interest in the partnership, or with the purpose of acquiring the whole or part of the deceased's share or like interest in the company or close corporation and any claim by the deceased against the company or close corporation; and
3. No premium on the policy was paid or borne by the deceased.

[18] Section 3(3)(a)(iA) of the Estate Duty Act 45 of 1955;

When the company is the owner of a policy and pays the premiums, this exemption in terms of Section 3(3)(a)(iA) of the EDA will not be applicable and estate duty will be payable on the value of the life policy proceeds.

4. Traditional buy-and-sell agreement

The above mentioned agreement is entered into between the shareholders[19] of a company[20]. In terms of this agreement the contracting parties agree that, when one of them dies, the remaining shareholder/s who signed this contract, will be obliged to purchase the shares from the deceased shareholder's estate. The purchase price will be paid to the estate, and will then be distributed by the executor, in terms of the deceased shareholder's will.

4.1. Tax implications of traditional buy-and-sell agreements

4.1.1. Dividend tax

On date of selling the shares, this agreement will be regarded as "disposal of assets". This will not be regarded as a dividend received from the company as for the fact that the company is not the buyer of the shares. The remaining contracting parties will be the buyers and therefor no dividend tax will be payable.

4.1.2. Income Tax

A buy-and-sell agreement may be funded with life policies which are owned by the contracting parties. The contracting parties will insure the life of the other parties and at date of death/disability the policies proceed will pay out to the policies owners. This will be used in terms of the agreement to buy the business interest from the effected party. These policies are not company owned policies and premiums paid may not be deducted from income tax in terms of section 11(w) of the Income Tax Act. As the premiums are not tax deductible, the proceeds of the policy will be exempt from income tax.

4.1.3. Capital gains tax (CGT)

For CGT purposes an asset is defined as:[21]

- Property of whatever nature (movable or immovable).

[19] This will also be applicable to members of a close corporation and partners in a partnership
[20] This will also be applicable to close corporations and partnerships
[21] Act 58 of 1962; Paragraph 1 of the Eight Schedule

- Including tangible and intangible assets (corporeal and incorporeal).
- Including rights or interest of whatever nature to or in such property.
- Excluding any currency (other than coins made mainly from gold or platinum).

CGT will not only be charged on profits made on the sale of assets, as any disposal or deemed disposal of all assets will be subject to CGT, where the proceeds on disposal of the assets exceed its base cost and are not included in "gross income" for income tax purposes. In terms of the Act the "taxable capital gain" must be included in the taxable income of a person for the year of assessment. The "taxable capital gain" is calculated in terms of the Eighth Schedule (the "Schedule") of the Act.[22]

Capital gains are included at 40% for natural persons and 80% for companies, trusts, close corporations, and legal entities on the "net capital gain" for the year of assessment. This is called the inclusion rate for tax purposes and will be taxed as taxable income on the marginal tax rate applicable.[23]

"Net capital gains" are all the capital gains for the year of assessment added together less the annual exemption (where applicable) and assessed capital loss brought forward from the previous year.[24]

When a business interest is sold this will be regarded as a disposal of assets and income tax will be payable on any taxable capital gain made on this disposal. With reference to proceeds of a life policy, no CGT will be payable on the proceeds of a life policy, if it is a pure risk policy[25] (i.e. the policy has no cash/surrender value) and will also not be applicable where the deceased is the original beneficial owner of the policy[26].

[22] Section 26 of the Income Tax Act 58 of 1962;
[23] Act 58 of 1962; Paragraph 10 of the Eight Schedule
[24] Act 58 of 1962; Paragraph 8 of the Eight Schedule
[25] Act 58 of 1962; Paragraph 55(1)(e) of the Eight Schedule
[26] Act 58 of 1962; Paragraph 55(1)(a) of the Eight Schedule

Example

Two shareholders in a company enter into a buy-and-sell agreement. Each shareholder holds 50% shares in the company. The total value of the shares in the company is R1,000,000. The total base cost of these shares is R100. The buy-and-sell agreement provides that if one of the shareholders should die, the other shareholder will buy the shares from the estate of the effected shareholder.

On date of death of 1 shareholder:

Value of shares (market value)	R500,000
Base Cost	(R 50)
Profit	R499,950
Value of the life policy	R500,000
Exemption in terms of Paragraph 55(1)(1)	(R500,000)
Profit	R 0
Total capital gain	R499,950

4.1.4 Estate duty

Estate duty will be levied on all property and deemed property of a natural person on date of death.

Property is defined as: [27]

- any right in or to property,
- movable or immovable,
- corporeal or incorporeal.
- Whether the assets is tangible or intangible.
- It includes ownership and any other interest in or right in property, such as the right to use or occupation.

In terms of the Estate Duty Act ("the EDA"), deemed property[28] includes the proceeds of all "domestic policies" on the life of a deceased and are deemed to form part of his or her property for estate duty purposes[ii].

[27] Section 3(2) of the Estate Duty Act 45 of 1955
[28] Section 3(3) of the Estate Duty Act

An exemption[29] applies if a policy on the life of a deceased is taken out to fund a buy-and-sell agreement, provided that the following requirements are met:

1. The policy was taken out or acquired by a person who, on the date of the death of the deceased, was a partner of the deceased, or held a share or like interest in a company in which the deceased, on that date, held a share or like interest; and
2. The policy was taken out or acquired with the purpose of acquiring the deceased's interest in the partnership, or with the purpose of acquiring the whole or part of the deceased's share or like interest in the company or close corporation and any claim by the deceased against the company or close corporation; and
3. No premium on the policy was paid or borne by the deceased.

Therefore, the market value of the business interest will constitute property the estate of the deceased owner and will be subject to estate duty as part of the taxable estate, whereas the policy proceeds will not be deemed property for estate duty purposes if the above requirements are met.

5. Example to compare share buy-back agreements and traditional buy-and-sell agreements:

Company ABC (Pty) Ltd is worth R32,000,000 and has 5 shareholders. Shareholder 1: John holds 20% shares; Shareholder 2: The trustees of New Family Trust hold 25% shares; Shareholder 3: Trustees of Nice Trust 20% hold shares; Shareholder 4: Nice View (Pty) Ltd holds15% shares and shareholder 5: John and Sons (Pty) Ltd holds 20% shares. They bought the shares for R1 per share in 2005. Assume that a 100 shares have been issued.

These shareholders ask you if they should effect life policies to fund the buy-back of the shares from the shareholders at date of death, Company ABC (Pty) Ltd should pay the premiums on these life policies and what agreement will be the most tax efficient.

With regard to the facts above and the questions the answers will be as follows:
Life policies are one of the easiest and the most cost effective way to fund a buy-back of shares at date of death. It should however be borne in mind finding via policies is not the only way to finance such an agreement.

[29] Section 3(3)(a)(iA) of the Estate Duty Act

What agreement will be most tax efficient? As mentioned above, there is not one size fits all. Both agreements will be applied to the shareholders and tax calculations will be done as on date of death. For purposes of this example:

(i) it is assumed that the shareholding is the only property in the estate (where applicable), and
(ii) the possible consequence that the share buy-back policy proceeds may increase the value of the company for estate duty purposes and the subsequent necessity of applying section 4(p) of the EDA has not been taken into account, and
(iii) it is assumed that the share buy-back agreement provides that the policy proceeds are not taken into account for purposes of valuing the shares on death, and
(iv) other costs and deductions that may be applicable in the estate has not been taken into account.

Shareholder 1: John 20% shares in personal capacity: Value is R6,400,000

TAX	**BUY-AND-SELL AGREEMENT**	**SHARE BUY-BACK AGREEMENT**
DIVIDEND TAX[30]	R 0.00	R32,000,000 x 20% shareholding = R6,400,000 x 20% dividends tax = R1,280,000
INCOME TAX[31]	R 0.00	R 0.00
CAPITAL GAINS TAX		
On the shares in the estate[32]	Proceeds R6,400,000 Less Base Cost (R20) Capital Gain R6,399,980 Less Abatement (R300,000) Net Capital Gain R6,099,980 Taxable capital gain (x 40% inclusion rate) R2,439,992 Capital gains tax (x 45% (assumed marginal tax rate) R1,097,996	R 0.00
On the life policy[33]	R 0.00	R 0.00

[30] Section 1 of the Income Tax Act 58 of 1962;
[31] Section 11(w) of the Income Tax Act 58 of 1962;
[32] Act 58 of 1962; Paragraph 35(3)(a) of the Eight Schedule
[33] Act 58 of 1962; Paragraph 55(1)(e) of the Eight Schedule

ESTATE DUTY		
Shares	R6,400,000	R6,400,000
Policy	R0[34]	R6.400,000
Gross Estate	R6,400,000	R12,800,000
Less: CGT	(R1,097,996)	(R0.00)
Less: Dividends Tax	(R0)	(R1,280,000)
Less: Section 4A	(R3,500,000)	(R3,500,000)
Dutiable Estate	R1,802,004	R8,020,000
x 20% Estate Duty	R360.401	R1,604,000
TOTAL TAX	**R1,458,397**	**R2,884,000**

Shareholder 2: The trustees of New Family Trust 25% shares: Value R8,000,000

TAX	BUY-AND-SELL AGREEMENT	SHARE BUY-BACK AGREEMENT
DIVIDEND TAX	R0	R32,000,000 x 25% shareholding = R8,000,000 x 20% dividends tax = R1,600,000
INCOME TAX	R0	R0
CAPITAL GAINS TAX		
On the shares in trust	Proceeds: R8,000,000 Base Cost: (R25) Gain: R7,999,975 Less: (R300,000) Gain = R6,399,980 x 40% inclusion rate = R6,399,980 x 45% (marginal tax rate) = R2,879,991	R0
On life policy	R0	R0
ESTATE DUTY		
Shares	R0 (in trust)	R0 (in trust)
Policy	R8,000,000	R8,000,000
Gross Estate	R8,000,000	R8,000,000

[34] Section 3(3)(a)(iA) of the Estate Duty Act 45 of 1955

Less: CGT Less: Dividends Tax Less: Section 4A Dutiable Estate x 20% Estate Duty	(R0) (payable by trust) (R0) (R3,500,000) R4,500.000 x 20% = R1,600,000[35]	(R0) (R0) (payable by trust) (R3,500,000) R4,500.000 x 20% = R1,600,000[36]
TOTAL TAX	**R4,479,991**	**R3,200,000**

Shareholder 3: Trustees of Nice Trust 20% shares: Value R6,400,000

TAX	BUY-AND-SELL AGREEMENT	SHARE BUY-BACK AGREEMENT
DIVIDEND TAX	R0	R32,000,000 x 20% shareholding = R6,400,000 x 20% dividends tax = R1,280,000
INCOME TAX	R0	R0
CAPITAL GAINS TAX Shares Policy	 Proceeds = R6,400,000 Base Cost = R20 Gain = R6,399,980 x 80% inclusion rate = R5,119,984 x 45% marginal tax rate = R2,303,992[37] R0	 R0 R0
ESTATE DUTY Shares Policy Gross Estate	 R0 (in trust) R6,400,000[38] R6.400,000	 R0 (in trust) R6,400,000[40] R6.400,000

[35] The exclusion provided for in section 3(3)(a)(iA) is not applicable in this instance, as the life assured will not be a shareholder in the company. The capital gain tax that is paid is also not deductible, as it is a liability of the trust, and not the estate of the deceased.
[36] The exclusion provided for in section 3(3)(a)(iA) is not applicable in this instance, as the life assured will not be a shareholder in the company. The capital gain tax that is paid is also not deductible, as it is a liability of the trust, and not the estate of the deceased.
[37] *Ibid*
[38] The exclusion provided for in section 3(3)(a)(iA) of the Estate Duty Act is not applicable in this instance, as the life assured will not be a shareholder in ABC (Pty) Ltd.
[40] The exclusion provided for in section 3(3)(a)(iA) of the Estate Duty Act is not applicable in this instance, as the life assured will not be a shareholder in ABC (Pty) Ltd.

Less: CGT Less: Dividends Tax Less: Section 4A Dutiable Estate x 20% Estate Duty	(R0[39]) (R0) (R3,500,000) R2,900.000 x 20% = R580,000	(R0) (payable by trust) (R0) (R3,500,000) R2,900.000 x 20% = R580,000
TOTAL TAX	**R2,883,992**	**R1,860,000**

Shareholder 4: Nice View (Pty) Ltd 15% shares (for purposes of this example assume that the deceased is the only shareholder in Nice View (Pty) Ltd and that the only asset that Nice View (Pty) Ltd possesses is the shareholding in ABC (Pty) Ltd): Value R4,800,000. Also assume that the value at death (proceeds) of Nice View (Pty) Ltd is equal to its base cost.

TAX	BUY-AND-SELL AGREEMENT	SHARE BUY-BACK AGREEMENT
DIVIDEND TAX	R0	R0[41]
INCOME TAX	R0	R0
CAPITAL GAINS TAX Shares	 Proceeds = R4,800,000 Base Cost = (R15) Gain = R4,799,985 x 80% inclusion rate = R3,839,988 x 28% marginal tax rate = R1,075,197	 R0
Policy	R0	R0

[39] The CGT payable in respect of the disposal of the shares in ABC (Pty) Ltd is not deductible, as it is payable by the trust and not the estate.
[41] Section 64F(a) of the Income Tax Act. The dividend is exempt, as we are dealing with one South African company paying a dividend to another South African Company.

ESTATE DUTY		
Shares (Nice View (Pty) Ltd)		
Policy	R4,800,000[42]	R4,800,000[45]
Gross Estate	R4,800,000[43]	R4,800,000[46]
Less: CGT	R9,600,000	R9,600,000
Section 4A	(R0)[44]	(R0)
Dutiable Estate	(R3,500,000)	(R3,500,000)
x 20% Estate Duty	R4,372,005	R6,100,000
	R874,401	R1,220,000
TOTAL TAX	**R2,602,396**	**R1,220,000**

Shareholder 5: John and Sons (Pty) Ltd 20% shares (for purposes of this example assume that the deceased is the only shareholder in John & Sons (Pty) Ltd and that the only asset that John & Sons (Pty) Ltd possesses is the shareholding in ABC (Pty) Ltd), Value of shares: R6,400,000.

Also assume that the value at death (proceeds) of John & Sons (Pty) Ltd is equal to its base cost.

TAX	BUY-AND-SELL AGREEMENT	SHARE BUY-BACK AGREEMENT
DIVIDEND TAX	R0	R0[47]
INCOME TAX	R0	R0
CAPITAL GAINS TAX		
Shares (payable by John & Sons (Pty) Ltd)	Proceeds = R6,400,000 Base Cost = R20 Gain = R6,399,980 x 80% inclusion rate = R5,119,984 @ 28% marginal tax rate = R1,433,596	R0

[42] For purposes of this example, it is assumed that the value the shares in Nice View (Pty) Ltd is equal to the value its shareholding in the ABC (Pty) Ltd.
[43] The exclusion provided for in section 3(3)(a)(iA) of the Estate Duty Act is not applicable in this instance, as the life assured will not be a shareholder in ABC (Pty) Ltd.
[44] The CGT payable in respect of the disposal of the shares in ABC (Pty) Ltd is not deductible, as it is payable by Nice View (Pty) Ltd and not the estate.
[45] For purposes of this example, it is assumed that the value the shares in Nice View (Pty) Ltd is equal to the value its shareholding in the ABC (Pty) Ltd.
[46] The exclusion provided for in section 3(3)(a)(iA) of the Estate Duty Act is not applicable in this instance, as the life assured will not be a shareholder in ABC (Pty) Ltd.
[47] Section 64F(a) of the Income Tax Act. The dividend is exempt, as we are dealing with one South African company paying a dividend to another South African Company.

Life policy	R0	R0
ESTATE DUTY Shares (John & Sons (Pty) Ltd) Life policy Gross Estate Less: CGT Section 4A of the EDA Dutiable Estate x 20% Estate Duty	 R6,400,000[48] R6,400,000[49] R12,800,000 (R0)[50] (R3,500,000) R9,300,000 R1,860,000	 R6,400,000[51] R6,400,000[52] R12,800,000 (R0) (R3,500,000) R9,300,000 R1,860,000
TOTAL	**R3,293,596**	**R1,860,000**

Based on the facts of the above scenario, where the shares held in the person's personal capacity, the sale on death will be more cost effective where a traditional a buy-and-sell agreement, funded with life policies, in entered into between the individual shareholders. In the above scenario, where the shares held in a trust or another company, the sale will be more tax effective if a share buy-back agreement is entered into between these shareholders and the company. Dividend stripping, as explained above, must also be taken into consideration when deciding which agreement will be more effective for the client.

The facts of each matter should however be assessed and clients should be informed about all options and consequences thereof, thus placing them in a position to make an informed decision.

6. Conclusion

As there are no one size fits all solutions in the financial industry the circumstances of each case need to be examined to determine whether a traditional buy-and-sell agreement or a share buy-

[48] For purposes of this example, it is assumed that the value the shares in John & Sons (Pty) Ltd is equal to the value its shareholding in the ABC (Pty) Ltd.
[49] The exclusion provided for in section 3(3)(a)(iA) of the Estate Duty Act is not applicable in this instance, as the life assured will not be a shareholder in ABC (Pty) Ltd.
[50] The CGT payable in respect of the disposal of the shares in ABC (Pty) Ltd is not deductible, as it is payable by John & Sons (Pty) Ltd and not the estate.
[51] For purposes of this example, it is assumed that the value the shares in John & Sons (Pty) Ltd is equal to the value its shareholding in the ABC (Pty) Ltd.
[52] The exclusion provided for in section 3(3)(a)(iA) of the Estate Duty Act is not applicable in this instance, as the life assured will not be a shareholder in ABC (Pty) Ltd.

back agreement should be entered into. It will all depend on the facts and the needs of the client.

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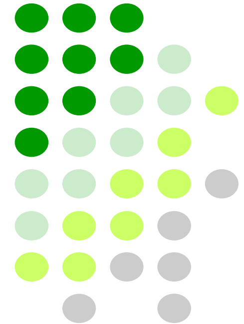

Income Tax

Taxability of Claims for Damages and Compensation

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Introduction

When a person suffers damages, loss or injury, he/she might have a contractual claim or a civil claim for compensation. There are certain requirements that will have to be proven to be successful with the claim for compensation. The manner in which the claim for damages is measured depends on the type of claim. This however falls outside the scope of this article.

In South Africa different types of taxes are levied based on income, wealth and consumption.[1] The question then arises as to whether an amount awarded in respect of a claim for damages and compensation will be taxable or not.

This article will attempt to determine if amounts received for claims of damages and compensation will be taxable from an income tax and an estate duty point of view.

Income Tax

In South Africa, income tax is levied in terms of the Income Tax Act[2], as amended from time to time. The Income Tax Act contains provisions for the levying of income tax, dividends withholding tax, donations tax and capital gains tax.[3] Taxes are payable by any person. A person for tax purposes includes an individual (a natural person), a company or close corporation (a juristic person), a trust, an insolvent estate, a deceased estate *et cetera*.[4] The South African tax system is partially a "resident based" system and partially source based, which in lay terms states that if a person is a South African resident or income is earned from a source within South Africa, he/she will be taxed on his/her world-wide income[5].[6] It is therefore clear that a person who has a claim for damages and compensation could be seen as "any person" for purposes of the Income Tax Act.[7] A person will however only be liable for income tax if taxable income[8] accrues to such person.

[1] AD Koekemoer *et al, SILKE: South African Income Tax at 11 (2018).*
[2] Act 58 of 1962.
[3] Premiums and Problems Edition 117 at A1 (2018).
[4] M Botha *et al*, The South African Financial Planning Handbook at 618 (2018).
[5] This is subject to the provisions of Double Tax Agreements entered into between South African and other countries, as well as specific provisions of the Income Tax Act that may exempt, or partially exempt income not from a South African Source in certain instances
[6] The definition of a South African resident for tax purposes falls beyond the scope of this article and will not be discussed further. Further information in this regard can be found in the Income Tax Act 58 of 1962. For purposes of this article, any reference to "a person" only relates to a South African resident.
[7] Act 58 of 1962.
[8] It falls outside the scope of the article to define the term "taxable income". Please revert to the Income Tax Act for the detailed definition of taxable income.

Now that it is clear that the Income Tax Act is applicable to a person who has a claim for damages and compensation it is important to understand that the starting point to calculate a person's taxable income is to determine what that person's "gross income" is.

Definition of "gross income"

In Section 1 of the Income Tax Act[9] gross income is defined as follows:

"gross income", in relation to any year or period of assessment, means -

i) in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or

ii) in the case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within the Republic,

during such year or period of assessment, excluding receipts or accruals of a capital nature…

The definition continues to include certain specific amounts in gross income, even where some of these specific inclusions are of a capital nature.[10]

A person must ask two questions to determine if an amount would be included in gross income or not for purposes of the Income Tax Act:

Question 1: Have any amounts, in cash or otherwise, been received by a person or accrued to a person? The answer will be yes even if there has been no physical receipt of an amount.[11]

Question 2: Is the amount that has been received by or accrued to of a capital nature or income nature? If the answer is that it is capital of nature then the amount will not be included in a person's gross income, unless the capital amount is specifically included as mentioned above.

When answering the two questions above in respect of an amount received by or accrued to a person as compensation, the following relevant points must be taken into account:

(i) An amount of compensation received or accrued can be seen as an amount that was received or accrued to a person for purposes of gross income. Therefore, the answer to question 1 would be "yes" an amount has been received or accrued.

[9] Act 58 of 1962.

[10] The definition of gross income in Section 1 of the Income Tax Act includes specific amounts in to the definition of gross income. The discussion of these amounts does not fall inside the scope of this article and will not be discussed.

[11] M Botha *et al*, The South African Financial Planning Handbook at 634 (2018).

(ii) In answering question 2 the main stumbling block will be to determine if the amount of compensation received or accrued is of an income nature or of a capital nature. Even though capital is not defined in the Income Tax Act it is usually fairly easy to determine whether an amount received or accrued will be capital of nature or not.[12] Amounts earned by a person from personal effort or from business or trade will normally not be capital in nature but income in nature. The 'Filling a hole' test could also be used in certain circumstances. The "Filling the hole' test is a test which is sometimes applied, when the receipt or accrual represents compensation, by asking whether the compensation was designed to fill a hole in the taxpayer's profits, or whether it was intended to fill a hole in his assets.[13] If the compensation is in respect of filling a hole in assets, it will in addition be necessary to determine whether the asset is of a capital or revenue nature. Compensation received in respect of the loss or sterilisation of a fixed capital asset is of a capital nature.[14] It is important to take note of a few relevant cases.

In *CIR v Illovo Sugar Estates Ltd*[15] it was held that the compensation received for the destruction of sugar cane plants that produced crops was of a capital nature, while compensation for growing crops was held to be of income nature.[16]

In the other case of *Estate AG Bourke v CIR*[17] compensation was received for the destruction of pine trees by fire. It was held here that the pine trees do not renew themselves once felled. The pine trees represent the crop and the soil represents the income-earning structure. In this case the loss of the pine trees is the same as the loss of the apples from an apple tree rather than to the loss of the apple tree itself.[18] The compensation received was held to be of an income nature.

The court held *in Taeuber and Corssen (Pty) Ltd v SIR*[19] that a restraint of trade payment was of a capital nature. It should however be noted that the Income Tax Act has since been

[12] M Botha *et al*, The South African Financial Planning Handbook at 638 (2018).
[13] SARS Capital Gains Tax Guide Issue 6 at 18 & *Burmah Steamship Co Ltd v IRC 1931 SC 156, 16 TC 67.*
[14] *The Glenboig Union Fireclay Co Ltd v Commissioner of Revenue 12 TC 427.*
[15] *1951 (1) SA 306 (N), 17 SATC 387.*
[16] SARS Capital Gains Tax Guide Issue 6 at 18
[17] *1991 (1) SA 661 (A), 53 SATC 86.*
[18] SARS Capital Gains Tax Guide Issue 6 at 18
[19] *1975 (3) SA 649 (A), 37 SATC 129.*

amended to include restraint of trade payments in the definition of gross income in Section 1 of the Income Tax Act.[20]

(iii) When it comes to assets it is not always that easy to determine whether the asset is a "capital" asset or not. There have been many cases that has determined whether an asset is a capital asset or part of a profit-making scheme.[21] It is not within the scope of his article to discuss whether an asset would be a capital asset or not. There are however two relevant cases that will be discussed below.

In *WJ Fourie Beleggings v C:SARS*[22] the taxpayer owned a hotel. The taxpayer concluded an agreement to accommodate a substantial number of persons over a period of time. The agreement was cancelled and the taxpayer received an amount of money for damages due to the cancellation of the agreement. The taxpayer argued that the agreement that was cancelled was part of its income-producing structure and of a capital nature.[23] The court however concluded that the agreement was concluded as part of the taxpayer's business of providing accommodation and therefore was a product of the taxpayer's income-earning activities and not the means by which it earned the income. The agreement was thus not of a capital nature and was seen as income in nature.

In *Stellenbosch Farmers' Winery Ltd v CIR*[24], the taxpayer received compensation for the premature cancellation of an agreement which gave him exclusive distribution rights of certain products for a fixed period. Here the court held that the exclusive distribution rights that the taxpayer held in terms of the agreement was a capital asset and as a result of the cancellation of the agreement the taxpayer lost a capital asset. The court concluded that the compensation received by the taxpayer was of a capital nature.

The reason why it is important to differentiate between income and capital is because income tax is taxed on income and not on capital. Capital on the other hand might be subject to capital gains tax and the rules contained in the Eight Schedule of the Income Tax Act. [25] Capital gains tax[26] is applicable to capital gains made after the date it came into

[20] Paragraphs (cA) and (cB) of the definition of 'gross income' in Section 1 of the Income Tax Act.
[21] M Botha *et al*, The South African Financial Planning Handbook at 639 (2018).
[22] (2009 SCA).
[23] AD Koekemoer *et al, SILKE: South African Income Tax at 49 (2018).*
[24] (2012 SCA).
[25] Act
[26] Was introduced with effect from 1 October 2001.

operation. Capital gains tax will only arise on the disposal or deemed disposal of an asset which is a capital asset.

This differentiation can have important tax implications. Capital gains are taxed at a maximum effective rate of 18% for individuals, 22,4% for companies and close corporations and 36% for trusts.[27] Amounts of an income nature, on the other hand, would be included into the gross income of a person would be taxed at that person's applicable tax rate which could be as high as 45% for individuals and trusts and 28% for companies.

It is important to note that a distinction must be made between a claim for loss of earnings and a claim for loss of earning capacity.[28] In *Barclay v Road Accident Fund*[29] the court mentioned that a claim for the loss of earnings is of an income nature and that a claim for the loss of earning capacity is of a capital nature. In Union Government (Minister of Railways and Harbours) v Warneke[30] the court stated the following:

"Skade is die ongunstige verskil wat deur die onregmatige daad ontstaan het. Die vermoënsvermindering moet wees ten opsigte van iets wat op geld waardeerbaar is en sou insluit die vermindering veroorsaak deur 'n besering as gevolg waarvan die benadeelde nie meer enige inkomste kan verdien nie of alleen maar 'n laer inkomste verdien. Die verlies van geskiktheid om inkomste te verdien, hoewel gewoonlik gemeet aan die standaard van verwagte inkomste, is 'n verlies van geskiktheid en nie 'n verlies van inkomste nie."

There is no golden rule for the distinction between loss of earnings and the loss of earning capacity. Each case must be treated on its own merits.

The court[31] further mentioned an award of damages, in the hands of the recipient takes on the character of the loss in respect of which it was paid.[32] Therefore if the payment is in respect of a loss of a capital nature, the award is similarly of a capital nature, but if the payment is in respect of a loss of income, the award is of a revenue nature.

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[27] M Botha *et al*, The South African Financial Planning Handbook at 639 (2018).
[28] *Tax in quantification of damages – Issue 171 December 2013*
[29] [2012] (3) SA 94 (WCC58 of 1962.).
[30] 1911 AD 657 at 665.
[31] *Barclay v Road Accident Fund [2012] (3) SA 94 (WCC).*
[32] *Barclay v Road Accident Fund [2012] (3) SA 94 (WCC).*

One has to consider what the impact will be on policies covering disabilities in the case of both lump sum payments as well as income payments. Where the payments is income in nature it will be exempted in terms of Section 10(1)(gl) of the Income Tax Act[33], which reads as follows:

(1) There shall be exempt from normal tax –

(gl)any amount received or accrued in respect of a policy of insurance relating to the death, disablement, illness or unemployment of any person who is insured in terms of that policy of insurance, including the policyholder or an employee of the policyholder in respect of that policy of insurance to the extent to which the benefits in terms of that policy are paid as a result of death, disablement, illness or unemployment other than any policy of which the benefits are paid or payable by a retirement fund;

The above section therefore exempts from income tax any amount received or accrued in respect of a policy of insurance if the policy relates to the death, disablement, illness or unemployment of any person who is insured in terms of that policy of insurance, including the policy holder, and the benefits are paid as a result of illness.[34]

The Eighth Schedule of the Income Tax Act contains certain exclusions for the proceeds of long-term assurance policies from capital gains tax (CGT). Two of the most important exclusions would be the disregarding of a capital gain by the original beneficial owner, his spouse, nominee, dependant or deceased estate of such a policy[35] and all pure risk policies with no cash value or surrender value. [36] [37]

Paragraph 59 of the Eighth Schedule [38] also contains an exemption relating to compensation for personal injury, illness or defamation. A natural person or a special trust must disregard a capital gain or a capital loss in respect of a disposal of a claim resulting in that person or trust receiving compensation for personal injury, illness or defamation of that person or beneficiary. The following is an example:

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[33] Act 58 of 1962
[34] Haupt, Phillip, Notes on South African Income Tax at 90 (2017)
[35] Paragraph 55(1)(a)(i) of the Eighth Schedule of the Income Tax Act 58 of 1962.
[36] Paragraph 55(1)(e) of the Eighth Schedule of the Income Tax Act 58 of 1962.
[37] There are various other exemptions in the Eighth Schedule that will not be discussed.
[38] The Income Tax Act 58 of 1962

Pieter's employer makes it impossible for him to do his work and makes it impossible for him to continue working for the employer. Pieter is forced to resign. Pieter approached various other employers for a job but his previous employers 'bad mouths' him each time a prospective employer's phones him for a reference. Pieter goes to the CCMA and is awarded R150 000 in respect for unfair dismissal. Pieter also receives R50 000 for a claim for defamation. The amount of R150 000 received in respect of unfair dismissal is taxable in Pieter's hands under para (d)(i) of the definition of 'gross income'[39]. The R50 000 received by Pieter for defamation, being of a capital nature and unrelated to his employment, falls outside para (d) and is excluded from CGT under paragraph 59.

This exclusion does not, however, extend to all forms of damages and compensation. A right to claim damages or compensation is an asset for CGT purposes, being a personal right. The receipt of those damages is a disposal of that right which may give rise to a capital gain. The base cost of the right may consist, for example, of the legal fees incurred in bringing the action to court.[40]

It is clear from the above that the answer to question 2 can result in adverse tax consequences.

It should also be noted that payments for damages or compensation resulting from negligence could be deductible in terms of the general deduction formula[41] in the hands of the payer thereof, but only if the negligence constitutes an inevitable concomitant of the trade. An example would be if a person sells petrol lamps under a guarantee as his principal business. There is an inherent risk of injuries if a lamp explodes. Payments for consequential damages and compensation would be incurred in the production of income due to the risk being an inevitable concomitant of the person's trade.[42]

Estate Duty

Estate duty is levied on the estates of deceased persons in terms of the Estate Duty Act.[43] It applies to the estates of all deceased persons who were resident in South Africa at the time of

[39] The Income Tax Act 58 of 1962
[40] The Comprehensive Guide to Capital Gains Tax, Issue 6 at 470.
[41] Section 11 (a) of the Income Tax Act 58 of 1962.
[42] AD Koekemoer *et al, SILKE: South African Income Tax at 131 and 132 (2018).*
[43] Act 45 of 1955.

their death.[44] For the purposes of the Estate Duty Act a person's estate consists of "property" and "deemed property" of the deceased at the date of death. Section 3 of the Estate Duty Act sets out what constitutes "property" and "deemed property".

"Property"[45] is defined as any right in or to property, movable or immovable, corporeal or incorporeal.[46] An amount for damages or compensation received by a natural person will give that natural person a right to that amount. The natural person would be able to use the amount of compensation as he deems fit, for example to invest that amount or purchase assets with it. Therefore, amounts received for claims for damages and compensation by a natural person will fall within the definition of "property" for estate duty purposes and will form part of such a deceased person's estate.

Conclusion

In respect of the Income Tax Act[47] claims for damages and compensation will thus be taxable in the hands of the person who receives it or to who it accrues. Whether the amount of compensation will be included in the gross income of a person all depends on whether it is regarded as being income in nature or capital in nature. If an amount of compensation is included in a person's gross income it may be taxed at the tax rate applicable to that person's taxable income for the year of assessment. If an amount of compensation is regarded as capital one has to consider the possibility of capital gains tax thereon in terms of the Eighth Schedule of the Income Tax Act.[48] Amounts seen as capital would be favourable in terms of the taxation thereof. It is important that all documentation relating to the nature of the said claims for damages and compensation and any amounts received or accrued be kept and safeguarded in order to provide the necessary evidence of the nature of such a claim and the amounts received or accrued as a result thereof. It is once again important to reiterate that the proceeds of policies with disability benefits will be tax free, but that the premiums payable on such a policy will not be deductible for tax purposes as governed by Section 23(r) of the Income Tax Act.[49]

[44] M Botha *et al*, The South African Financial Planning Handbook at 775 (2018).
[45] Section 3(2) of the Estate Duty Act 45 of 1955.
[46] M Botha *et al*, The South African Financial Planning Handbook at 776 (2018).
[47] Act 58 of 1962.
[48] It must be remembered that CGT will only be triggered if there is a disposal and that disposal leads to a capital gain. Where it is compensation for an asset, there may be deemed to be a disposal of the asset, or it may be rolled over depending on the circumstances. All of the exemptions contain in the Income Tax Act and the Eighth Schedule needs to be taken into account, especially Paragraph 65 relating to involuntary disposals.
[49] Act 58 of 1962.

In respect of estate duty, it is clear that all property of a deceased person who was a resident in South Africa will form part of that person's deceased estate. All property will therefore include any amounts received for claims of damages or compensation and any subsequent property (investments, movable assets etc.) acquired with it.

Financial planners should take note of the taxability of claims for damages and compensation and make provision therefor where required.

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Salary vs Dividends vs Loans – How to Receive the Profits from the Business?

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Introduction

Depending on the relevant circumstances, there may be different options to compensate business owners with regards to their proprietorship in a company or close corporation. The choice exercised in this regard is important from a tax perspective. Business owners have one of three methods that can be used for this purpose, but the tax implications of each need to be carefully considered. Business owners can opt for one or more of the following methods by which to be rewarded viz. a salary (assuming that the business owner is also employed by the business), dividends and loans from the company.

This article will consider the tax implications of the above mentioned methods that a business owner can apply to access profits from the business. This article will not propose which method is more favourable, as it will be dependent on the facts of reach matter

Example Facts

The following example demonstrates the tax implications of all three options: Mr A (45 years old) is the 100% member of XYC (Pty) Ltd and is also employed by this company. The annual taxable profits before taxation of the company are R1 000 000. The client wants to take this full amount in cash.

Salary

If Mr A takes the net profits as a salary, the tax implications will be as follows:

a) Tax on profits payable by company

If all the profits are payable by the company to Mr A as a salary, the company will not pay any tax on the R1 000 000.

Section 11(a) read with section 23(g)[1], allows for the deductions of expenses provided that the company is carrying on a trade and the expenditure and losses are actually incurred in the production of income, which is not of a capital nature. This allows Mr A to receive the profits as a salary from the company and then it can claim the salary as business expenses thereby reducing the taxable income of the company.

[1] Income Tax Act 58 of 1962

b) Tax on salary of R1 000 000 (using 2019/2020 tax tables)

The salary will be taxed according to the marginal tax rate of Mr A. We will assume that the Mr A has no other sources of income and no exemptions or deductions and that he is a member of medical aid (no dependents).

Gross income		R1 000 000
Less: Exemptions	*(R0)*	
Less: Deductions	*(R0)*	
Taxable income		R1 000 000
Tax as per tax tables (2019/2020)	R207 448 + 41% of the amount above R708 310	R327 041
Less: Primary rebate	*R14 220*	
Less: Medical aid tax credit	*R3 720* *(R310 x 12)*	
Tax payable		R309 101
Effective tax rate	(309 101 / R1 000 000)	30.91%
Net income after taxation		R690 899

Dividends

Mr A can elect to receive profits by way of dividends from the company. The tax implications will be as follows:

a) Tax on profits payable by company

The company will be pay at 28% on the annual profits before distributing the net profit to Mr A as a shareholder. The tax payable at 28% on R1 000 000 will be about R280 000. Mr A will receive a dividend of R720 000 from the company (R1 000 000 less R280 000).

b) Dividends withholding tax (DWT)

DWT at 20% on R720 000 will be R144 000. This is payable to the SARS by the company and balance of R576 000 is payable to Mr A.

Total amount of tax payable would thus be: R280 000 (income tax payable by company) + R144 000 (dividend withholding tax) = R424 000. The effective tax rate will thus be R424 000 ÷ R1 000 000 x 100 = 42.4%.

Loan

Mr A can receive the profits from the business by way of debit loan account. Loan accounts of this nature are usually interest-free loans. However, the Income Tax Act deems interest free or low-interest loans as a dividend.[2] This is only applicable where the loan is made to a natural person who is a connected person in relation to the company (in this instance Mr A would be as his holds more than 20% shareholding in the company).

a) Tax on profits payable by company

The company will pay income tax at 28% on the annual profits before distributing the net profit to Mr A as a shareholder. The tax payable at 28% on R1 000 000 will be R280 000. Mr A will then borrow R720 000 from the company.

No interest charged

If the company did not charge an interest on the loan account of R720 000, then according to the Income Tax Act, this will constitute a deemed dividend. For purposes of this example we will assume that the South African Revenue Services official interest rate is 7.75%.[3] The term official rate of interest is linked to the repurchase rate plus one percent.[4] Therefore, the deemed dividend on R720 000 at 7.75% will be R55 800. Dividend withholding tax at 20% on R55 800 will amount to R11 160.

Mr A will receive thus receive the following amount after tax: R1 000 000 – R280 000 (company tax) – R11 160 (dividend withholding tax) = R708 840. The total amount of tax payable will be: R280 000 (company tax) + R11 160 (dividend withholding tax) = R291 160. The effective tax rate will be: R291 160 ÷ R1 000 000 x 100 = 29.12%. However, if the loan account is still outstanding in

[2] Section 64E(4) of the Income Tax Act 58 of 1962
[3] Section 1(1) of the Income Tax Act 58 of 1962 (From 01/12/2018 to 31/07/2019)
[4] Section 1 of the Income Tax Act 58 of 1962

the following tax year, then dividend withholding tax of R11 160 will be payable in the following year, assuming that the rate for dividend withholding tax and the official interest rate remain unchanged.

Analysis

The effective tax rate for all three options are thus as follows:

1. Salary - 30.19%
2. Dividends – 42.4%
3. Loans – 29.12%

The advantage of receiving the profits by way of salary is that the company can claim the salary paid to the business owner as tax deduction, thereby decreasing the taxable income of the company. However, the salary must be aligned with the industry that the company operates in and the salaries paid to individuals performing the same task as the business owner in question. [5]Further, the business owner can reduce his taxable income by mean of a section 11F[6] deduction by contributing to a retirement fund.

Receiving the profits by way of a dividend is beneficial to the business owner where his marginal rate of tax exceeds 20% (i.e. the rate of dividend tax), but it must be born in mind that the effective rate of tax will be higher (42.4% as indicated above), due to the company not being able to claim the payment of the dividend as a tax deduction to reduce its taxable income. Further the company in distributing the dividends must guard against it being viewed as payment for services rendered (which will result in it being taxed as income in the hands of the business owner).[7]

Whilst the effective tax rate for receiving profits by way of loans is lowest in the example above, the loan account will always remain the same if the loan remains outstanding in succeeding years and will increase if this method is used on a year to ear basis. The business owner is further unable to claim any deductions or exemptions against the loan to reduce his taxable income and the medical tax credit regime will not be available to reduce the tax payable. If the

[5] Amanda Visser: Salary Payment Still Best Option for Business Owners (6th June 2018)
[6] Income Tax Act 58 of 1962
[7] Amanda Visser: Salary Payment Still Best Option for Business Owners (6th June 2018)

dividends tax withholding rate or official rate of interest is increased, it will impact negatively on interest free loans from companies to shareholders.

In addition, in the event of the company facing insolvency, the creditors of the company can attach all assets belonging to the company including the debit loan account. This will impact the shareholder's estate negatively from a cash flow perspective. The outstanding loan will be a debt in the estate of the shareholder that needs to be settled, should he die or decide to sell the shares. If the company then decides not to pursue the claim, it could be viewed as a donation on the part of the company which would result in donations tax payable by the company at 20%. In the event of the shareholder's death, the company has the right to claim full and final settlement of the loan account which could impact the liquidity in the estate.

Conclusion

There is no rule to state which option a business must select when receiving the profits from the company. Although the effective tax rate is one of the aspects to be considered in choosing the relevant method, all the factors and circumstances in each matter need to be taken into account in making such a decision. A combination of options could also be chosen to ensure the most efficient outcome for both the company and the shareholder.

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Retirement Annuity Deductions for SA Tax Residents Earning Foreign Remuneration

Old Mutual
Personal Finance: Legal

Introduction

South African tax residents are taxed on foreign remuneration earned working outside of the country. In 2001 South Africa changed from 'source' based taxation to 'residence' based taxation. This means that South African residents are taxed on their worldwide income regardless of where the source of that income is.

Currently foreign remuneration is exempt from tax in South Africa if certain conditions are met. The exemption applies to remuneration received in respect of services rendered outside the Republic if that employee was outside the Republic for a period exceeding 183 days which includes a period that exceeds 60 consecutive days and those services were rendered during those periods.[1] Remuneration includes salary, leave pay, wage, overtime pay, bonus, gratuity, commission, emolument or allowance and fringe benefits and benefits under employee share schemes. From 1 March 2020 only the first R1 000 000 of such qualifying remuneration will be exempt. How does this change impact on the limits for retirement annuity deductions in section 11(F)(2) of the Income Tax Act[2]?

Section 11(F)(2):

The deduction so allowed must not exceed the lesser of:

(a) R350 000;

(b) 27,5% of the higher of

  (i) remuneration or

  (ii) taxable income; or

(c) taxable income before

  (i) allowing any deduction under this section and section 6 quat(1)C and section 18(A) and

  (ii) the inclusion of any capital gain.

Example 1

Mr X, a SA tax resident, working in SA earned a salary of R 2 000 000. He also sold his townhouse and made a taxable capital gain of R 1 000 000 in the 2019/2020 tax year. In terms of section 11F(2) his maximum allowable deduction would be calculated as follows :

[1] Section 10(1)(o)(ii) of the Income Tax Act 58 of 1962

[2] 58 of 1962

The lesser of:

(a) R350 000

(b) 27,5% of the higher of:

(i) R2 000 000 (remuneration) = R550 000 or;

(ii) R3 000 000 (taxable income of R2 000 000 salary plus R1 000 000 taxable capital gain) = R825 000

or

(c) R2 000 000 (taxable income before capital gain)

Therefore, the lesser of:

(a) R350 000

(b) R825 000 or

(c) R2 000 000

= R350 000 (maximum allowable deduction under Section 11F)

Any contributions in excess of R350 000 will roll over and rank as contributions in the following tax year[3].

Should Mr X however have been employed outside the Republic e.g. in Namibia[4], and qualify for the section 10(1)(o)(ii) exemption, what would his allowable deduction be?

As section 10(1)(o)(ii) is an exemption the calculation is as follows:

The lesser of

(a) R350 000

(b) 27,5% of the higher of

(i) R2 000 000 (remuneration) = R550 000 or;

(ii) R1 000 000 [R2 000 000 gross income minus R2 000 000 salary exempt under section 10(1)(o)(ii) plus R1 000 000 taxable capital gain] (taxable income) = R275 000

or

(c) R0 [R2 000 000 gross income minus R 2 000 000 salary exempt under section 10(1)(o)(ii) = R0 taxable income before capital gain]

[3] Section 11F(3)

[4] For purposes of this example the provisions of the double tax agreement between South Africa and Namibia, and in particular the provision of article 15 read with article 23 thereof, have been ignored.

Therefore the lesser of :

(a) R350 000

(b) R550 000

or

R0

= R0 (therefore no deduction would be allowed under section 11F)

If the facts are exactly the same, but the salary is earned and the taxable capital gain made in the 2020/2021 year of assessment, Mr X's allowable maximum deduction under section 11F would be as follows:

The lesser of:

(a) R350 000

(b) 27,5% of the higher of

(i) R2000 000 (remuneration) = R550 000 or

(ii) R2 000 000 [Gross income (salary) R2000 000 minus only R1000 000 of salary exempt under the amended section 10(i)(o)(ii) = R1000 000 + R1000 000 taxable capital gain] = R550 000

or

(c) R 1000 000 (after R 1000 000 exemption on salary and before capital gain)

Therefore, the lesser of

(a) R350 000

(b) R550 000

(c) R1 000 000

= R350 000 (maximum allowable deduction under Section 11F)

Any disallowed contribution from the previous tax year would rank as a contribution in the current tax year[5].

Should Mr X qualify for a rebate for tax paid in Namibia on his salary, would it make a difference to his allowable retirement annuity deduction? The Income Tax Act[6] allows for a rebate for tax paid on foreign income earned from a foreign source. Rebates do not affect "taxable income"

[5] Section 11F(3) of the Income Tax Act 58 of 1962
[6] Section 6quat(1) of the Income Tax Act 58 of 1962

and therefore should not have any bearing on the retirement annuity deduction. This is also confirmed in section 11F(2)(b) and section 11F(c)(i) of the Income Tax Act[7].

Full commutation of fund interest in your retirement annuity

Could Mr X commute his full fund interest in a retirement annuity to a lump sum [should the fund interest not be less than R7 000[8]] prior to normal retirement age if he decides to 'formally emigrate'?

The definition of a 'retirement annuity fund' provides that the Commissioner shall not approve a fund if he is not satisfied that the rules of that fund provide –

(x) that a member who discontinues his contributions prior to his retirement date shall be entitled to –

(dd) the payment of a lump sum benefit where that member –

(A) is a person who is or was a resident who emigrated from the Republic AND that emigration is recognized by the South African Reserve Bank for purposes of Exchange control.

One would thus be able to commute your retirement annuity if your emigration is recognised by the South African Reserve Bank.

The South African Reserve Bank defines an 'emigrant' as a SA resident who has taken up permanent residence in any country outside the CMA (Common Monetary Area). The CMA consists of South Africa, Namibia , Lesotho and Swaziland (Eswatini).[9]

Therefore, Mr X would not be able to commute his full fund interest in a retirement annuity prior to retirement date to a lump sum should he decide to 'emigrate' to any of the countries in the CMA.

[7] 58 of 1962
[8] par(x)(cc) of the definition of a 'retirement annuity fund' in section1 of the Income Tax Act
[9] Currency and Exchange Guidelines for Individuals 2019-04-18

Conclusion

Many South African tax residents who work in foreign countries intend to return and retire in the Republic. They often do not belong or contribute to foreign retirement funds. With the changes to Sec 10(1)(o)(ii) of the Income Tax Act with effect from 1 March 2020 many could now face Income tax burdens. Prudent financial planning for those affected could alleviate both their tax burden and provide for their retirement.

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South African Residents Working Abroad: An Income Tax Perspective

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Introduction

There are two main reasons why people generally move abroad. The first is connected to family reasons and improving their lifestyle and the second is to take on a new challenge, gain new experiences and progress up the career ladder to remain gainfully employed. With many organisations operating across borders it has to be understood that one remains potentially liable to income tax in more than one country irrespective of where that income is being earned. While foreign taxation legislation may also affect individuals working abroad; a fact which should always be kept in mind; foreign taxation legislation shall not be dealt with in this article.

Throughout this article words importing the singular number include the plural and vice versa; words importing gender include all genders; and words importing persons include individuals.

The Income Tax Act

South Africa's tax system is residence-based[1] and the possible income tax payable by South African residents is governed by the Income Tax Act of South Africa[2] (hereinafter referred to as 'the Act').

The Act, while a complex piece of legislation, makes use of a number of carefully defined terms. In particular, there is a technical distinction between the terms 'gross income', 'income', 'taxable income' and being a "resident".[3]

As will become apparent later in this article there is a general tax rule which provides that South African residents are subjected to income tax on amounts received or accrued to them in respect of services rendered or by virtue of employment, anywhere in the world. They are also taxed on prescribed amounts usually linked to the cost to their employers of providing a variety of non-cash benefits to them[4]. Lastly, some of these amounts or benefits may be taxed at special rates or even be exempt from tax in certain circumstances. In all cases, it is therefore important to ensure that the applicable tax rules are properly understood, since small differences in facts can lead to different tax treatments faced by individuals[5].

[1] This has been so since years of assessment commencing on or after 1 January 2001 (SARS' Interpretation Note 4, released 3 August 2018).
[2] Income Tax Act 58 of 1962 (as amended).
[3] Inf.
[4] As provided for in the Seventh Schedule to the Act. See also SARS' External Guide for Employers in Respect of Fringe Benefits, released 20 February 2019.
[5] Section 1 of the Act.

Being a "resident" for income tax purposes

One of the most important aspects deciding whether a person will be subject to South African tax legislation is if that person is deemed a resident for Tax purposes. Under South African Law there are different types of residents. In terms of the Act, you are either a resident in terms of "physical presence test" or ordinarily resident in terms of the Common law.

A person will be 'resident'[6] if they are:

(a) Ordinarily resident in South Africa (by which is meant that South Africa is the place, on a holistic view of personal and financial circumstances, to which the person would naturally return from their occasional travels, and which is their real home[7]); or

(b) not ordinarily resident in the current tax year but physically present in South Africa for more than 91 days in the current tax year, physically present for an aggregate of more than 915 days in the *preceding* five years and physically present for more than 91 days in each of those preceding years.

This time-based rule is subject to the provisos that:

1) For purposes of determining the 91- and 915-day periods, a part of a day will count as a full day; and
2) where a person is physically outside South Africa for a continuous period of at least 330 full days after the day of last physical presence, that person will not be resident under the time-based rule for the entire period of continuous absence.

The South African Revenue Service' ('SARS') Interpretation Note 3 (Issue 2)[8], confirms that a physical presence is not a prerequisite to be ordinarily resident in the Republic as the purpose, nature and intention of a person's absence must be established and considered holistically in determining whether that person is ordinarily resident in South Africa[9].

[6] Ibid.
[7] *Cohen v Commissioner for Inland Revenue (*1946 AD 174, 13 SATC 362 at 373)
[8] Released 20 June 2018.
[9] In the matter of *Cohen v Commissioner for Inland Revenue (*1946 AD 174, 13 SATC 362 at 373) *t*he court, inter alia, held that ordinary residence was not determined solely by the facts applicable to a particular year of assessment. In addition, the court found that a natural person could be ordinarily resident in a country for a year of assessment even if that person was physically absent from that country for that entire year.

A person may not be treated as a South African resident for tax purposes if considered to be a resident, for tax purposes, of another country in terms of a double taxation agreement[10] (DTA). In a double taxation agreement, the typical progressive tie-breaker tests[11] used are[12]:

Where does the person have a permanent home available?

(a) If the person has a permanent home available in both contracting countries, he is required to consider in which contracting country his/her personal and economic relations are closer.

(b) If a decision cannot be made as to which country serves as the person's nexus of vital interests, he should consider in which country he spends most of his time and has his habitual abode.

(c) If it cannot be said that his habitual abode is one of the contracting countries, the test is which country that person is a national of.

(d) Where the person is a national of both countries, it is left to the competent authorities of both contracting countries together to decide.

If found, in the final analysis, to be a resident, then from a general perspective, the resident's worldwide income must be included in his gross income in terms of section 1 of the Income Tax Act as would his worldwide capital gains be included in his taxable income in terms of section 26A of the Income Tax Act in accordance with the rules of the Eighth Schedule.

Gross income

The definition of 'gross income' in relation to any year or period of assessment includes in the case of residents, the total amount, in cash or otherwise, received by or accrued to a taxpayer during that year or period, excluding receipts and accruals of a capital nature but including certain specific items (whether or not of a capital nature)[13]. In the case of non-residents, only income from a South African or a deemed South African source is included. Therefore, remuneration can fall within the tax net only if the following conditions, as shall be dealt with below, are met:

[10] A bilateral, two-party, agreement made by two countries to resolve issues involving double taxation of passive and active income. Tax treaties generally determine the amount of tax that a country can apply to a taxpayer's income, their capital, estate, or wealth. South Africa is a signatory to double tax treaties with several countries throughout the world.

[11] Tie-breaker clauses in DTA may differ and it is important to consider the specific DTA in each case.

[12] SAICA Emigrant Guide. 2018: 10-12.

[13] Section 1 of the Income Tax Act

(a) A receipt or accrual must have taken place;

(b) the receipt or accrual must have taken place during the period or year of assessment concerned, and

(c) the receipt or accrual must not be of a capital nature unless specifically included in the definition by way of one of the special rules.

A South African resident, therefore, must include taxable amounts in its gross income in the year that these amounts are "received by" **or** "accrue to" that taxpayer.

Receipt or accrual

When to actually include a particular receipt or accrual in an income tax return is important to understand for if it is included in a year later than required, penalties and interest will be payable to SARS. Conversely, if a receipt or accrual is included in an earlier year, then the payment of tax would have been unnecessarily advanced[14]. But while the inclusion of a receipt or accrual is important it is also important to realise that the meaning of the terms "receipt" and "accrual" has not been defined by the Act but by our judiciary[15]. Briefly, a "receipt" takes place for tax purposes when an amount is received by the taxpayer on his own behalf and for his own benefit. "Accrual" takes place when the right to receive an amount is absolute and there is no contractual uncertainty or contingency even though payment may only be due in the future. If an amount has been "beneficially received" there is a receipt for tax purposes and thus no need to determine whether there is an accrual. It is only when there is no receipt that it must be determined whether there is an accrual.

The receipt or accrual need not only be in cash but can also be in 'kind', such as the use of a motor car, as the preamble to the 'gross income' definition expressly refers to receipts and accruals 'in cash or otherwise' and that it is to be valued at its fair market value at the date of the award.

As indicated above, the general taxation rule brings into the tax net any amount received or accrued in the year concerned (that is, the tax year) in respect of services rendered or to be rendered. But while South African residents are subject to income tax on their worldwide income,

[14] Clegg, D. *Concise Guide to Employee Taxation*, 2019 at 2.1

[15] In practice, the meaning of the concept accrual is governed by the interpretation given to it in the case of Lategan *v CIR (1926* CPD 203), as confirmed in *CIR v Peoples Stores (Walvis Bay) (Pty) Ltd* 1990 (2) SA 353 (AD).

it is nevertheless to be noted that section 10(1)(o)(ii) of the Act currently contains an important exemption that applies to certain South African resident employees working outside the Republic of South Africa.

South African residents working outside the Republic

As introduced above, South African residents are subject to South African income tax on their worldwide income. However, section 10(1)(o)(ii) of the Act currently provides for an exemption from South African income tax where services are rendered by a South African resident outside of South Africa for any employer. This provision sets out two qualifying conditions:

(a) The period or periods outside the Republic must exceed 183 full days in aggregate during any 12 months, and

(b) the composite of the aggregate days must include a continuous period outside the Republic exceeding 60 full days.

By way of illustration[16]

Z is employed by the South African subsidiary of a multi-national company. Due to specialised knowledge, Z was requested to assist a New Zealand subsidiary and left the Republic on 1 May 2014 to commence work on 2 May 2014. Z was contracted to work in New Zealand until 19 December 2014. The subsidiary company in New Zealand remunerated Z during this period. Z departed New Zealand on 20 December 2014 to return to the Republic.

Z returned to the Republic to fulfil local employment obligations during the following periods, which include travel days*:*

- *22 June 2014 to 6 July 2014;*
- *30 August 2014 to 7 September 2014; and*
- *11 November 2014 to 20 November 2014.*

Result:

The number of calendar days during which remuneration was derived from services rendered in New Zealand in the 2015 year of assessment is as follows:

[16] This example can be found in SARS' Interpretation Note No. 16 (issue 2) on page 9.

	May	*Jun*	*Jul*	*Aug*	*Sep*	*Oct*	*Nov*	*Dec*	*TOTAL*
2 May 14 to 21 June 14	*30*	*21*							*51*
7 July 14 to 29 Aug 14			*25*	*29*					*54*
8 Sept 14 to 10 Nov 14					*23*	*31*	*10*		***64***
21 Nov 14 to 19 Dec 14							*10*	*19*	*29*
									198

The total remuneration that Z received for services rendered during the period 2 May 2014 to 19 December 2014 is R500 000.

As the table above indicates, the taxpayer satisfies the requirements of the 183-day and 60-continuous-day tests within a period of 12 months.

Where an employee qualifies for the *section 10(1)(o)(ii)* income tax exemption, the *employee* also qualifies for an exemption from employees' tax since employees' tax is merely a monthly part payment in respect of the liability for normal tax of an employee and if there is no normal tax liability in respect of the amount paid, there can also be no employees' tax liability.

Of importance to individuals currently working abroad, or planning to take up employment abroad, is that, in terms of the 2017 amendments to the Income Tax Act, the *section 10(1)(o)(ii)* exemption for employment income will only apply to remuneration that does not exceed R1 million with effect from 1 March 2020. As a result of this amendment to the Act, all South African residents will be subject to tax on foreign employment income earned in excess of R1 million in respect of services rendered outside South Africa on behalf of any employer (even non-South African employers). It is also very important to note that employment income includes salary, leave pay, wage, overtime pay, bonus, gratuity, commission, fee, emolument and allowances. However, any foreign taxes that have been paid on the amount to be included in income can be claimed as a rebate under section 6*quat* of the Act[17]. What this means for individuals in countries such as Dubai, for example, is that employment income earned in excess of R1 million by South African residents in tax havens (i.e. where no tax is paid, or where the rate of tax is very low) will now be subject to tax in South Africa, but subject to the foreign tax rebate in respect of any foreign taxes paid.

[17] Inf.

By way of illustration, as provided in the SAICA Emigrant Guide[18], consider the following:

Mr R (South African resident) works in Mauritius and earns the equivalent foreign employment income of R1 500 000 and R100 000 of rental income in South Africa. He is subject to tax in Mauritius at a rate of 15%.

(Assuming it is the 2021 tax year and the South African marginal tax rates has remained the same)

	R
Foreign income	1 500 000
SA income	100 000
Section 10(1)(o)(ii) exemption	(1 000 000)
Taxable income	600 000
SA tax payable (R147 891 + (R600 000 – R555 600) x 39%))	166 791
Primary rebate	(14 067)
Section 6quat(1) rebate Foreign tax: R1 500 000 x 15% = R225 000 Limit: R500 000/R600 000 x R153 291 = R127 732	(127 732)
Total SA tax payable	**25 559**

With regards the requirement of foreign employment income earned is that there must be a link between the remuneration received and the services rendered outside South Africa and the remuneration must be received during the year of assessment in which the 12-month period commences or ends.

As the exemption only applies to remuneration for services rendered it is vital, from an income tax perspective, to note that -

(a) certain employment-related payments that do not relate to actual services rendered; such as restraint of trade payments, gratuities, or severance benefits on retrenchment; and
(b) income from the conducting of trade as a sole proprietor or via a partnership (which does not constitute remuneration),

does not fall under the exemption provided by *section 10(1)(o)(ii)*[19].

[18] 2018: 18-19.
[19] SAICA Emigrant Guide. 2018: 17.

And while a potential exemption under *section 10(1)(o)(ii)* with regards to foreign employment income earned exists, this potential exemption does not automatically waive the liability of an employer to deduct employees' tax in terms of the Fourth Schedule to the Act. Where it is found that the exemption was not applicable, the employer would be held liable for the employees' tax not deducted as well as the concomitant interest and penalties.

Also, an exemption under the provisions of *section 10(1)(o)(ii)* does not mean that the employer or an employee is absolved from its liability for unemployment insurance fund contributions[20] under the Unemployment Insurance Contributions Act[21] and Skills Development Levies Act[22].

Application of section 6quat of the Act as alluded to above[23]:

Section 6quat(1)

A South African tax resident can claim a tax rebate against his South African tax of foreign taxes paid on non-South African sourced taxable income.

Example:

A South African resident derives a foreign income of R100 on which foreign taxes of 25% (R25) are proved to be payable. The South African resident's effective tax rate is 28%.

Solution

	R
Taxable income from a foreign source	100,00
Normal tax (28%)	28,00
Less: Foreign tax rebate	(25,00)
Final normal tax payable	3,00
Total tax (normal tax and foreign tax)	**28,00**

Section 6quat(1C)

A South African tax resident can claim a tax deduction on foreign taxes paid on South African sourced taxable income.

[20] SARS' Interpretation Note No. 16 (Issue 2), page 15.
[21] No 63 of 2001.
[22] No. 97 of 1998.
[23] The examples used were taken directly from the SAICA Emigrant Guide 2018: 20 – 22.

Example:

A South African resident derives South African income of R100 on which foreign taxes of 25% (R25) are proved to be payable. The South African resident's effective tax rate is 28%

	R
Taxable income from a South African source	100,00
Less: Foreign taxes qualifying for the deduction	(25,00)
Taxable income after deduction of foreign taxes	75,00
Normal tax (28%)	21,00
Total tax (normal tax and foreign tax)	**46,00**

Section 6quat(1B) (a) - limitation of tax rebate

The amount of foreign taxes which qualify for the section 6quat (1) rebate in a particular year of assessment is the lesser of –

- the sum of the qualifying foreign taxes; or
- the amount calculated under the limitation formula as set out below.

The limitation formula is calculated as follows:

Taxable income derived from all foreign sources (A) x Normal tax payable on (B)

Taxable income derived from all sources (B)

"***Taxable income derived from all foreign sources***" includes all amounts of foreign source income that were included in the South African resident's total taxable income regardless of the rate of foreign tax (if any) to which those amounts are subject. The taxable income of both the numerator and the denominator is determined according to South African tax law.

Normal tax is the South African tax calculated on taxable income before the deduction of any rebates contemplated in *sections 6, 6A, 6B*, 6quat (1) and 6quin, respectively.

The purpose of the limitation is to ensure that the rebate granted for foreign taxes paid only relates to the foreign income included in a resident's taxable income. Therefore, if no foreign income is included in a resident's taxable income, no foreign tax rebate will be available even if the resident paid foreign tax.

All qualifying foreign taxes are aggregated and the rebate is limited (capped) at the lesser of the aggregate of the foreign taxes payable and the proportion of normal tax payable on the resident's foreign taxable income as calculated by the limitation formula.

The following example illustrates the application of this limitation:

Facts:

A South African resident earns foreign income from services rendered in Country A.
In year 1 his gross income equals R100 000 and expenses allowable as a deduction are R80 000.

Country A levies tax on services at a rate of 10% on gross receipts, which means that the tax payable in Country A is R10 000 (being R100 000 × 10%) for year 1.

The South African resident has other taxable income of R50 000 sourced in SA and his effective tax rate is 28%. His normal South African tax totals R19 600 [(R50 000 + R20 000) × 28%].

Result:

The full amount of foreign tax paid of R10 000 potentially qualifies for the rebate, but the general limitation must be taken into account.

Calculation of limitation – using a formula:
<u>Taxable income derived from all foreign sources</u> × Normal tax payable
Taxable income derived from all sources
= R20 000 / R70 000 × R19 600
= R5 600

Rebate in year 1 = R5 600
Excess of R4 400 (R10 000 – R5 600) may be carried forward to year 2 to potentially qualify for a foreign tax rebate in year 2

Possible benefits covered under *section 10(1)(o)(ii)*

a) Employer-paid visits to South Africa

When employees are on long term foreign assignment, it is quite common for the employer to pay for the cost of a vacation visit home in order for its employee to keep contact with family; but are these "benefits" taxable?

Section 10(1)(o)(ii) is quite clear in this regard. If the employee falls within the time parameters, then the exclusion is for any remuneration so derived in respect of services rendered outside of South Africa.

The costs of the airline tickets are usually purchased in terms of the contract of employment under which those services are rendered and, as such, the benefit flowing from the payment of travel costs is exempted under the said section.

b) Employer-paid visits for a spouse to a foreign location

Allowing for monthly visits to South Africa would cause the employee to transgress the 60-day limit in *section 10(1)(o)(ii)* but what if the employer paid for the employee's spouse to visit the employee instead?

Paragraph 16(2) of the Seventh Schedule to the Act provides that a benefit granted to the relative of an employee is treated for tax purposes as though the benefit had been granted to the employee himself. However, where the spouse or a dependent of the employee should visit the employee in South Africa, who is away from his usual place of residence for more than 183 days, and she travels more than 250 kilometres from the employee's usual place of residence, the traveling costs associated with the visit will be exempt. As discussed above, the benefit of travel costs paid by the employer should fall within the parameters of *the section 10(1)(o)(ii)* exemption as there seems to be no logical distinction to be drawn in the case of a spouse's travel.

Could the decision to fly the spouse to join the employee be attacked under the general anti-avoidance provision of *section 80A*? *Section 80A* of the Act provides that SARS may not only challenge the reasons for entering into a specific transaction or series of transactions but may also challenge the reasons for entering the transaction or series of transactions in a specific manner. In addition, because *section 80G* presumes, until the contrary is proved by the taxpayer, that the transaction was entered into or carried out solely or mainly for the avoidance of tax, the onus will be on employee/employer to prove that the avoidance of tax was not the principal reason for the spouse's visit.

c) Sick leave

Where a person who has already complied with the exemption requirements of *Section 10(1)(o)(ii)* in a year of assessment, spends vacation leave or sick leave in South Africa during the same year of assessment, the remuneration received by the person during the period of leave will continue to be exempt from tax in terms of *Section 10(1)(o)(ii)* to the extent that the remuneration is attributable to the number of vacation or sick leave days credited to the employee in respect

of and during the period of service outside South Africa that is similar to vacation or sick leave benefits that generally prevail for persons employed in South Africa.

d) Share options exercised outside the Republic

Where a South African company allows the employee to participate in a share option scheme, and an employee exercises an option during the period of service outside the Republic, the *section 10(1)(o)(ii)* exemption would apply in respect of *sections 8A, 8B* and *8C* gains.

The terms of the share option scheme would dictate the basis for share option offers. Where the allocation of an option is linked to future services and part of those services are rendered outside the Republic, then the *section 10(1)(o)(ii)* exemption would apply to the part rendered outside the Republic.

e) Annual bonus paid to employee outside the Republic

In a similar context to the preceding paragraph, if an employer pays annual bonuses and a bonus payment is made whilst the employee is rendering services outside South Africa (but for less than the bonus period) the bonus will be apportioned between the period of services rendered in and outside of South Africa. That portion of the annual bonus as is ascribed to services rendered inside of South Africa would, therefore, be subject to taxation in South Africa and should be disclosed on the employee's IRP5 as 3605 Annual payment.

f) Exchange control

All South African residents are subject to the regulations which restrict the transfer of funds abroad.

Residents may:

1) Not operate foreign bank accounts without permission.
2) Not maintain income and funds abroad except for employment income from services actually rendered outside South Africa to a foreign employer.

Transfers of amounts of up to R10 000 000 offshore are subject to a tax clearance certificate issued by SARS. In addition, up to R1 000 000, within the single discretionary allowance facility, can be transferred abroad, without the requirement to obtain a Tax Clearance Certificate.

Documentation required by SARS in respect of individuals claiming the section 10(1)(0)(ii) exemption on assessment

As proof of entries and exits from South Africa could be requested to prove compliance with the provisions as set out in section 10(1) (o) (ii) of the Act it is suggested that the following documentation should be provided by the taxpayer to prove his/her absence from South Africa in order to claim the exemption provided for in section 10(1)(o)(ii), in the case where the employee is being remunerated by a South African company:

1) contract of employment;
2) copies of passport evidencing periods spent out of the country;
3) IRP5 certificate for the period during which PAYE was deducted; and
4) IT3(a) certificate for the period during which remuneration was paid to the employee and no PAYE withheld.

Where the employee is being remunerated by a non-South African company, the taxpayer would need to submit only the contract of employment stipulating, inter alia, the remuneration earned during the period for which the exemption is being claimed, and copies of his/her passport evidencing the periods during which he was out of the country.

Other tax planning considerations

a) Relocation allowance

Section 10(1)(nB) provides that where an employee's relocation expenses are paid for by an employer as a consequence of being transferred from one place of employment to another, such relocation expenses are exempt from South African tax. Section 10(1)(nB) may be relied on in respect of transfers within South Africa. Therefore, an employer may pay relocation expenses to and from the foreign country without creating a taxable fringe benefit in the employee's hands.

Relocation expenses covered by the provisions of this section include the following:

1) The cost of transporting the employee, his possessions and his household goods;
2) settling-in expenses; and
3) the rental expense of hiring residential accommodation for a period limited to a maximum of 183 days from the date of transfer.

With effect from 1 March 2016, the commissioner's discretion to allow an amount equal to one month's salary to be treated as a tax-free settling-in allowance was removed. Accordingly, a settling-in allowance paid via payroll to an employee should be treated as a taxable allowance.

b) Other sources of income

South African residents are subject to South African income tax on their worldwide income. For those residents who satisfy the conditions for exemption available under section 10(1)(o)(ii), it needs to be noted that the exemption is only in respect of remuneration paid where services are rendered by a South African resident outside of South Africa for any employer. The balance of taxable income derived from sources outside of employment remains subject to taxation in South Africa.

Examples of the tax treatment of other sources of income are:

i) Rental income

Residents renting their principal residence in South Africa whilst working abroad for the period of secondment are subject to South African income tax on the rental income received. Certain expenses incurred in the generation of this income are deductible from the rental income, for example repairs and maintenance (not improvements), property rates or levies, the cost of water and electricity (if included in the rental charge to occupants), interest charges in respect of a mortgage bond on the property, rental collecting agent's fees, etc.

ii) Dividend and interest income

Dividend distributions by a South African company are exempt from taxation in South Africa. Certain exemptions apply to foreign dividends received by or accrued to a South African tax resident[24], such as:

(a) The full foreign dividend where the South African resident shareholder holds at least 10% of the total equity shares or voting rights of the company declaring the foreign dividend; or
(b) For a natural person, 25/45 of the foreign dividend is exempt (if the above does not apply).

All interest income received by a resident natural person[25] under 65 years in the 2018/2019 year of assessment is subject to taxation in South Africa to the extent that they exceed R23 800 (R34

[24] Section 10B of the Act
[25] Section 10(1)(i) of the Act

500 in the case of individuals older than 65 years) per annum. Foreign interest is, however, not exempt.

iii) South African unit trusts

The dividend component of South African unit trust distributions is exempt from taxation in South Africa. The interest component of South African unit trust distributions is subject to taxation in South Africa to the extent that it exceeds the R23 800 per annum exemption (see above).

Exclusions from taxable income

There are relatively few exemptions from income tax on remuneration for services rendered. For purposes of this article, the principal exclusions are set out below:

Offshore oil and gas operations

This exclusion deals with South African resident individuals who work as crew on (typically) oil and gas prospecting or production platforms in parts of the world other than South Africa and its continental shelf. Note that in the case of such platforms which are on the South African continental shelf, no exclusion applies and the remuneration of both resident and non-resident individuals are included in South African taxable income

Foreign pensions

Any amount received by a resident of South Africa under a foreign government's social security system is exempt. [26]

Similarly, any lump sum, pension or annuity received by or accrued to a South African tax resident from a source outside South Africa as compensation for past employment outside South Africa is currently exempt from South African taxation[27]. In other words, to the extent that the lump sum, pension or annuity paid from an unapproved retirement fund can be said to have been funded from services rendered outside South Africa (whether before, during or after South African tax residency) that portion would be exempt from South African tax in the hands of a South African tax resident. [28]

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[26] Haupt, P. *Notes on South African Income Tax* (2019) on page 81

[27] Section 10(1)(gC) of the Act.

[28] Section 10(1)(gC) must be read in conjunction with section 9(2)(i) which deals with the apportionment of source of a pension, pension lump sum, or annuity.

In addition, depending on the law in the country where the particular retirement fund is located, the lump sum, pension or annuity might be taxable in that specific country. However, some Double Tax Agreements may provide sole taxing rights to South Africa as the country of residence, although such right may be made subject to the amount being taxed in South Africa.

Payments from a South African retirement fund received by a resident for past employment outside of South Africa is however fully taxable.

Crews of ships in international traffic

The below-mentioned exclusion[29] applies irrespective of the residence of the individual concerned but requires the taxpayer to be physically outside the Republic for a period (or periods) exceeding 183 full days in the aggregate in the South African year of assessment concerned. The exemption applies to remuneration derived as an officer or crew member of a ship engaged:

(a) In international transportation for a reward of passengers or goods. Transportation for 'reward' envisages that the ship owner should be remunerated for the carriage by a third person and the exclusion would not apply to the crew of a vessel which carries it owner's own goods from point to point for commercial advantage but not 'reward'.

(b) In prospecting for or mining of any minerals (including oil or gas) from the seabed *outside* the Continental Shelf where the person concerned is employed on board the vessel solely for purposes of its international passage ie., as a seaman member of the crew rather than as a technical or scientific member.

Payment in foreign currency

When payment is made to an employee in foreign currency his taxable income must be translated to South African Rands by applying the spot rate on the date that the amount was received. However, if the employee makes an election, he can translate payments made to him in foreign currency by applying the average rate for the relevant year of assessment, as published by SARS.

[29] Section 10(1)(o)(i) of the Act

Conclusion

The decision to work abroad is a decision justifiably fraught with many concerns of which the liability of tax is often the lowest. Tax, and in particular income tax, is an ever-present reality and so too the fact that countries, and their national borders, are getting closer following technological advancements in all spheres of life. As the liability for income tax is a reality it remains the responsibility of an astute taxpayer to seek expert professional advice prior to following any decided course of action.

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Intellectual Property in Financial Planning

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Introduction

An estate's most valuable and enduring asset may not necessarily be a well located property or a well-run business. To some individuals their intellectual property, can possibly make up a large part of their estate, but also provide income for generations if dealt with wisely and if well-advised. This article sets out some practicalities of dealing with intellectual property in financial planning.

Intellectual property in South African law is a term that describes the application of the mind, informally termed "brain child", to develop something novel and original. [1] Some are registered and some need not be. This intangible asset therefore affects and finds application in nearly every industry. Some examples: in the publishing industry, an author's intellectual property over their book; in the music industry, a musician's intellectual property over the piece of music composed; the pharmaceutical company over some medical breakthrough drug to name but a few.

Intellectual property therefor can exist in many different forms from new inventions, to brand design, to artistic creation. In South Africa different intellectual property are governed by different legislation.

As a financial planner of a client with an intellectual property, it is necessary to identify what type of intellectual property your client holds.

A brief discussion of the most commonly held intellectual properties in South Africa:

Trademarks

Trademarks are a unique mark which distinguishes a good or service from one another[2]. They include logo designs, slogans, distinctive shapes and dimensions of products. When we consider the red and white ribbon design we immediately associate it with the Coca Cola brand, and on hearing *"I'm Lovin' it!"* one knows that it is a McDonalds reference. This is how powerful trademarks are. The owner of the Trademark has the exclusive right to use, sell or licence the trademark. In South Africa trademarks are governed by the South African Trademarks Act[3].

[1] www.cipc.co.za Companies and Intellectual Property: What is IP? accessed 05/07/2019
[2] www.cipc.co.za/index.php/trade-marks-patents-designs-copyright/trade-marks/ accessed 5 July 2019
[3] South African Trademarks Act 194 of 1993

Trademarks are applied for and filed in the Companies and Intellectual Property Commission (CIPC) and once issued, registration is valid for 10 years from date of registration and is to be renewed every 10 years for the validity to stand.

Trademarks are fully transferable and hence may be bought or sold to another party. The use of a trademark may only be done with the consent of the trademark owner and commonly in exchange for money.

Copyrights

Copyrights are regulated by the Copyright Act[4]. Another form of intellectual property, which protects original works of authorship. It includes literary, dramatic, musical, poetry, novels, movies songs and computer software to name but a few. In terms of the Act copyrights need not be registered for the author or creator to enjoy and enforce their rights of authorship and it can endure for fifty years after an individual has died. The owner of a copyright has the exclusive right to use, sell or license the copyright work.

Patents

Patents are governed by the South African Patent Act[5]. A patent is what protects a new invention from being reproduced or achieving what the invention sets out to do. Inventing the first laundry appliance which both washes and dries clothing in one cycle may require that the invention be patented. Such patent needs to be applied for to the Patent Office when validly issued the right endures for a maximum of 20 years in exchange for the worldwide public disclosure of the patent.

A few important mentions is that the said invention is to be new worldwide and can be made at a point that it is just an idea, as long as the idea has been sufficiently developed to a point where it can fully put into practice. An actual prototype need not yet be developed.[6]

The owner of a patent has the exclusive right to use, sell or license the invention. In the event that the patent is licenced, the patents licences are lucrative as the holder can either manufacture the invention or and generate income from the sales, or the patent owner can license another party to manufacture and thereby derive income from granting/selling the license to such other party.

[4] Copyright Act 98 of 1978
[5] South African Patent Act 57 of 1978
[6] www.jbs.co.za/index.php/commercial/intellectual-property-patents-explained accessed 1 July 2019

Ownership of Intellectual Property

In the process of financial planning it is necessary to establish the true ownership of an intellectual property.

By way of example, it is said that if an individual who creates an original piece of music but has not signed a deal with a publishing company, then it can be said that the person fully owns their own music. Often in the music trade a song, which is a highly collaborative piece of art has different persons who are the lyricists, people who write the instrumental tune, the party who publishes it. Who then owns it?

For this reason, we distinguish the creator/inventor of the intellectual property from the owner of the intellectual property.

The Performers Protection Act[7] along with the Copyright Act in this scenario seek to safeguard the creator of the intellectual property who owns a copyright in it whilst they are alive. As mentioned this copyright endures for 50 years after the creator's death[8]. The benefit of owning the intellectual property is that anyone who reproduces, uses, downloads in in any form must obtain permission from the owner, the owners rightful heirs or rights holders beforehand, and such persons should pay for using it.

As an owner of the intellectual property one may cede partially or outright ones right to the intellectual property to other parties like publishers, producers or manufacturers (as in the case of invented goods). If this patent/copyright/trademark/ to a creator's work vests in another party then simply put the ownership no longer vests in the creator.

Conversely if the ownership vests in the creator then take cognisance of the value and nature of the asset being dealt with.

Royalties

An owner of an intellectual property may cede partially or outright its right in the intellectual property to other parties. It may also sell the use, right of use or permission to use the intellectual property. This payment for the use of the intellectual property is known as a royalty.[9]

[7] Performers Protection Act 11 of 1967
[8] Copyright Act S of Act 98 of 1978
[9] S 9 (1)-(3) Income Tax Act 58 of 1962

The terms of the royalty payments are negotiated for and housed within a royalty agreement. If a royalty payment is received by a client, then such royalty should be included in their gross income and hence subject to income tax.

Estate Duty

Estate duty is a tax levied at a rate of 20%, payable on a deceased estate with a net value is in excess of R3, 500,000. The estate is constituted of all property and deemed property of a person at the date of death.

S3(2) of the Estate Duty Act [10] defines property as any right in or to the property, moveable or immoveable, corporeal or incorporeal. It therefore includes both physical tangible assets (e.g. houses, cars) and intangible assets (e.g. patents, trademarks copyrights).

S3(2) (f) states that "Property" [does not include] any goodwill, licence, patent, design, trade mark, copyright or similar right not registered or enforceable in the Union or attaching to any trade, business or profession in the Union"

It is hereby evident that if the intellectual property is registered in the name of the person then it is to be included in the estate as property and is there subject to estate duty. This once more reinforces the importance of having the asset properly valued for calculating liquidity needs in estate plans[11]

As mentioned before copyrights do not need to be registered for an author to obtain protection, and these copyrights due to it not being registered therefore fall outside the estate which incurs estate duty.

Conclusion

Financial planners should consider all assets when conducting a client needs analysis. Intangible assets like intellectual property could make up a sizeable asset within a client's estate and for this reason should not be ignored where calculations of estate duty and liquidity shortfalls are concerned.

[10] Estate Duty Act 45 of 1955
[11] Practical consideration for valuing intellectual property assets in Estate Planning, By Denis S Rahne and Shira T Shapiro. Published in Probate & Property Volume 31 Number 4 by the American Bar Association

The very nature of an intellectual property is an individual's personal stamp on the world and as such it should be determined what that individual's wishes over the asset, patent, registered copyright, trademark etc. is after the individual's death when developing the estate plan and when drafting the clients will. This is an asset which may be bequeathed and potentially provide income to heirs for years after the owner's death

Establish if ownership vests in client. Establish what rights client may have had over intellectual property. Merely being the so-called "creator" of the intangible asset may not always result in the creator also having unfettered rights of ownership to the intellectual property. Registering the said intellectual property is key, as is determining if the ownership rights are shared with other collaborating or involved parties e.g. manufacturers, publishers etc.

This is a highly specialised field and for that reason it would be prudent to obtain a qualified appraiser for the intellectual property to determine the value of the asset and also an intellectual property lawyer to assist in accurately determining a client's short to long term rights to the asset and its future fruits, so that all may be factored into the client's financial plan.

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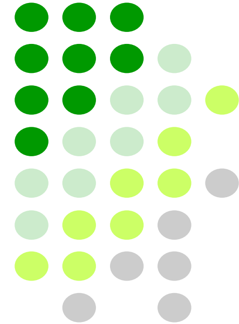

Investment Planning

Section 12J Investments

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Introduction

Many South Africans are seeking opportunities to save tax within the parameters of the Income Tax Act. [1]

Section 12J Investments was introduced by the South African government in 2009[2] as a tax incentive to encourage equity investment through a venture capital company (VCC)[3] in small and medium sized businesses and junior mining companies. These type of investments gained traction round about 2014 when amendments were made to make the tax deduction towards a Section 12J investment permanent if the investor holds the shares issued by the venture capital company for at least 5 years[4]. Section 12J allows a holder of shares to claim a 100% deduction of the cost of the shares issued by the VCC, provided certain requirements are met[5]. The 2019 Taxation Laws Amendment Act however amended Section 12J of the Income Tax Act to limit the maximum tax deduction in a particular year of assessment to R5 million for a company and to R 2.5 million for a person other than a company[6]. This amendment is effective in respect of any Section 12J investment made on or after 21 July 2019.

If an investor sells his shares before expiry of the 5 year term, SARS will recoup the value of the deduction, i.e. include it in the taxable income of the taxpayer[7]. The section is effective for venture capital shares acquired on or after 1 July 2009 but on or before 30 June 2021[8].

There is no legislative minimum requirement for investment in a VCC in terms of Section 12J but most VCC require a minimum investment of at least a R 100 000 but more often R500 000. Therefore, these type of investments are mostly suited for your high net-worth investors. Individuals, companies and trusts can invest in a Section 12J VCC and get a tax benefit of up to 45% (assuming an individual in the highest tax bracket or a trust other than a special trust).

[1] Income Tax Act 58 of 1962
[2] Section 27(1) of the Revenue Laws Amendment Act 60 of 2008
[3] Section 12J(1) of the Income Tax Act
[4] Section 12J(2) and 12J(9) of the Income Tax Act
[5] Section 12J(2) of the Income Tax Act
[6] Section 17(1)(c) of the 2019 Taxation Laws Amendment Act 34 of 2019
[7] Section 12J(9) read together with Section 8(4)a of the Income Tax Act
[8] Section 12J(11) of the Income Tax Act

Examples

	Individuals/Trusts	Corporates
Initial Investment	R 2 500 000	R5 000 000
Tax relief	(R1 125 000)*	(R1 400 000)
Net Investment (risk capital)	R1 375 000	R3 600 0000

*assumes individual in the highest marginal tax bracket

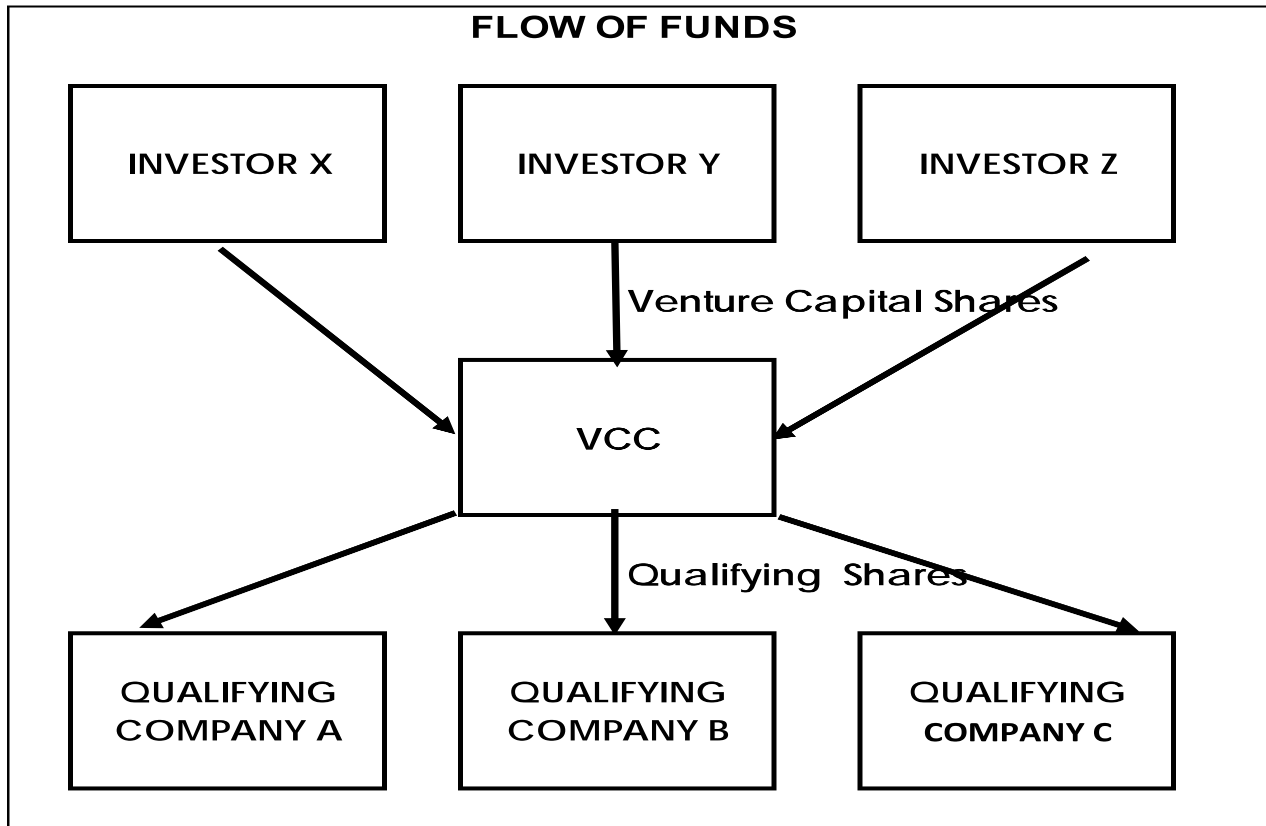
Venture Capital Companies (VCC)

A Section 12J (VCC) is a company which has been registered as a Financial Service Provider (FSP) under section 7 of the Financial Advisory and Intermediary Services Act 37 of 2002[9] with the Financial Sector Conduct Authority (FSCA) and has been approved by the Commissioner under Section 12J(5) as a "venture capital company". The main objective of a Section 12J (VCC) is to manage investments in qualifying companies which should stimulate local investment in small and medium enterprises (SME's). A VCC cannot, in addition to managing investments in qualifying companies, run any other business or manage a trading or long-term investment portfolio in non-VCC investments[10]. A list of approved venture capital companies can be found on the SARS website.

Section 12 J VCCs can invest in most businesses if the qualifying company holds assets not exceeding the book value thresholds of R 50 000 000 or R 500 000 000 in the case of any junior mining company[11]. Examples of qualifying businesses include (but are not limited to):

- agriculture businesses;
- mining and contracting businesses;
- franchises;
- hotel, lodge, student residence and B&BS
- general SMEs
- renewable energy businesses; and
- manufacturers

[9] This section relates to the authorisation of financial service providers.
[10] Section 12J(5) of the Income Tax Act
[11] Section 12J(6A)(b) of the Income Tax Act



Deduction available to investors

Section 12J (2) allows the taxpayer a deduction from income for expenditure actually incurred in acquiring any venture capital shares issued by a VCC, subject to certain conditions.

The deduction is available only for expenditure incurred by a taxpayer to acquire venture capital shares issued to the taxpayer by the VCC subject to Sections 12(J) 3, 3(A) and 4. No deduction will be allowed in respect of venture capital share purchased from a third party[12] and no deduction will be allowed in respect of shares acquired after 30 June 2021[13].

Only the costs directly connected with the acquisition of the venture capital shares are deductible. Banking costs and those costs related to obtaining a loan (financing cost) are indirect costs and will not be allowed as a deduction[14]. For example, if a taxpayer incurs financing cost of R6 000 on a loan of R100 000 which was used to acquire 100 venture capital shares at a

[12] Section 12J(2) read with section 12J(3), (3A) and (4) of the Income Tax Act
[13] Section 12J(11) of the Income Tax Act of the Income Tax Act
[14] SARS Draft guide on venture capital companies –page 5

cost of R1 000 per share, only the R100 000 acquisition cost will be available as a tax deduction and not the R6 000 financing cost.

The deduction can be off-set against all types of taxable income which makes it particularly attractive to those investors who have incurred capital gains tax during the year of assessment. Should an investor with a marginal tax rate of 45% invest R 1000 000 into a Section 12J VCC in the current tax year he would be able to shield R450 000 of tax subject to the condition that the investment is held for a minimum period of 5 years. This essentially means the individual makes a net investment of R550 000. SARS is effectively sponsoring the R450 000 because instead of paying SARS R450 000 you are investing it in a Section 12J company.

When the investor in the above example sells his venture capital shares in the 12J VCC at the end of the 5 year term he will be liable for capital gains tax on the entire investment meaning the base cost used will be nil[15]. Therefore, assuming the fund keeps the money intact in the above example, and pays the R1000 000 back after 5 years, this amount will be multiplied by an inclusion rate of 40% (assuming an individual investor) and then multiplied by his marginal rate of tax: R1000 000 X 40% X 45% (assuming a marginal tax rate of 45% for purposes of this example) = R180 000 capital gains tax liability. The investor will thus receive R820 000 after tax at the end of the 5year investment period.

The impact of the section 12J investment on the section 11F Deduction

An important consideration for an individual investor when investing in a Section 12J investment is the impact this investment will have on his contributions towards retirement funds.

Section 12J(2) provides as follows:

(2) Subject to subsection (3), (3A) and (4), there must be allowed as a deduction from the income of a taxpayer expenditure actually incurred by that taxpayer in acquiring any venture capital share issued to that taxpayer by a venture capital company.[16]

[15] Section12J(2) of the Income tax Act 58 of 1962 and paragraph 20(3)(a)of the Eighth Schedule to the Income Tax Act

[16] Income Tax Act 58 of 1962

Section 11F (2) provides as follows:

(2) The total deduction allowed in terms of subsection (1) must not in a year of assessment exceed the lesser of—

(a) R350 000;

(b) 27, 5 per cent of the higher of the person's—

(i) remuneration (other than in respect of any retirement fund lump sum benefit, retirement fund lump sum withdrawal benefit and severance benefit) as defined in paragraph 1 of the Fourth Schedule; or

(ii) taxable income (other than in respect of any retirement fund lump sum benefit, retirement fund lump sum withdrawal benefit and severance benefit) as determined before allowing any deduction under this section and sections 6quat (1C) and 18A; or

(c) the taxable income (other than in respect of any retirement fund lump sum benefit, retirement fund lump sum withdrawal benefit and severance benefit) of that person before—

(i) allowing any deduction under this section and sections 6quat (1C) and 18A; and

(ii) the inclusion of any taxable capital gain.[17]

When analysing section 11F the following issues are important:

- When calculating the 27.5% from a taxable income point of view, the 27.5% is calculated by calculating cross income, deducting exempt income, deducting deductions (except the section 18A and section 6quat deductions[18]) and adding taxable capital gain. When a taxpayer earns remuneration the 27.5% is merely calculated on the value of the remuneration – this is then compared to the value of taxable income as set out above, and the higher amount may be used for purposes of the 27.5% deduction.
- For purposes of further limiting the deductible amount the deduction may effectively not exceed taxable income before the section 18A deduction and section 6quat deduction is applied, and before the taxable capital gain is added to the taxable income[19].

The effect of the above is that the section 12J deduction must first be deducted from taxable income when calculating the 27.5% deduction in respect of taxable income[20]. The taxable

[17] Income Tax Act 58 of 1962
[18] Section 11F(2)(b)(ii) of the Income Tax Act
[19] Sec 11F(c)(i) and (ii) of the Income Tax Act
[20] Section 11F(2)(b)(ii) of the Income Tax Act

income will thus effectively first be reduced by applying the section 12J deduction as section 11F(2)(c) does not provide that this deduction is applied before the section 12J deduction.

Example: Taxable Income[21]

A sole proprietor has a taxable income of R 900 000 for the tax year .This person can therefore contribute R 247 500 (27.5% of taxable income)[22] to a retirement annuity in the year of assessment. The contribution would be tax deductible in terms of section 11F[23].

If this same person now invests R 450 000 in a section 12J investment in the year of assessment the maximum deduction to a retirement annuity would be limited to R 123 750:

R900 000 (Gross Income) - R450 000(Sec12J Investment) = R450 000(taxable income) x 27.5% R 123 750.

His taxable income for the year would be as follows:

R900 000 - R450 000 - R123 750 = R326 250.

Example: Remuneration[24]

We are dealing with the exact same person as in the example above except the taxpayer is now earning remuneration of R900 000 for the year of assessment. For purposes of section 11F the remuneration of R900 000 would be higher than taxable income after the section 12J investment is deducted (i.e. R450 000). The taxpayer will still be able to get the full deduction in respect of section 11F and section 12J:

R900 000 (remuneration) x 27.5% = R247 500 (section 11F deduction)

Taxable income for the year:

R900 000 (gross income) – R450 000 (section 12J deduction) – R247 500 (section 11F deduction):

= R202 500

The conclusion drawn from the above two examples is that the person earning remuneration of R900 000 will be entitled to a R247 500 deduction in terms of section 11F, whereas the self-

[21] As defined in the Income Tax Act 58 of 1962
[22] In this instance the sole proprietor would not earn any remuneration, as provided for in the Income Tax Act.
[23] Income Tax Act 58 of 1962
[24] As defined in the Income Tax Act 58 of 1962

employed person earning taxable income of R900 000 will be entitled to a section 11F deduction amounting to R123 750.

It is important for financial advisors to advise their clients correctly where the client is already making use of the section 11F deduction towards a retirement fund and also wants to invest in a section 12J investment in order to get the relevant tax deduction in terms of section 12J(2).

Recoupments and Capital Gains Tax: Section 8(4) (a) and Section 9C

General recoupments are provided for in section 8(4)(a) of the Income Tax Act. Under this section any amounts allowed as a deduction under specified sections, which have subsequently been recovered or recouped by the tax payer, are included in the taxpayer's gross income under paragraph (n) of the definition of "gross income" in section 1(1)[25].

The sale of venture capital shares by an investor may therefore potentially result in the inclusion of the amount in the gross income of that investor where the amount was previously allowed as a deduction under section 12J that is subsequently recouped or recovered by the taxpayer.

However section 12J(9) provides that, despite section 8(4)(a), no amount shall be recovered or recouped in respect of the disposal of a venture capital share or in respect of a return of capital if that share has been held by the taxpayer for a period longer than 5 years.

Section 9C[26] deals with circumstances where certain amounts received or accrued from the disposal of shares are deemed to be of a capital nature. Section 9C(2) deems any amount (other than a dividend or foreign dividend) received or accrued or any expenditure incurred in respect of an equity share to be of a capital nature if such share was held for a period of at least three years. Section 9C(2A) provides that section 9C(2) does not apply in respect of so much of the amount received or accrued in respect of the disposal of an equity share contemplated in that subsection, other than an equity share held for longer than five years, as does not exceed the expenditure allowed in respect of that share in terms of section 12J(2).

[25] As defined in the Income Tax Act 58 of 1962

[26] The information on section 9C in relation to section 12J and the example has been extracted from Interpretation Note 43" Circumstances in which Certain Amounts Received or Accrued from the Disposal of Shares are deemed to be of a Capital Nature".

Thus section 9C(2) (deeming any amount received or expenditure incurred in respect of a share held more than 3 years)will not apply:

(a) in respect of proceeds received on the disposal of a share, and

(b) to *the* extent that such proceeds are not more than the expenditure allowed as a deduction on acquisition of venture capital shares, except

(c) *where* such share is held for longer than 5 years.

A return of capital received or accrued on the venture capital shares more than five years after they were issued must be dealt with under paragraph 76B(3) of the Eight Schedule of the Income Tax Act, since it will exceed the base cost of the venture capital shares resulting in a capital gain. Since the expenditure incurred in acquiring the VCC shares would have been allowed as a deduction against income under section 12J(2), it will be reduced to nil for purposes of determining the base cost of the VCC shares under paragraph 20(3)(a) of the Eighth Schedule to the Income Tax Act 58 of 1962.

Application of section 9C (2A) on disposal of venture capital shares

Facts:

Company X, acquired shares in an approved VCC on 1 March 2014 for R 400 000 (financial year end is 28 February 2014). On 30 September 2017 Company X sold these shares for
R 900 000[27].

Result:

2015 year of assessment

Company A qualified for a deduction of R 400 000 under section 12J (2)

2018 year of assessment

Upon disposal of the shares, R 400 000 is recouped under section 8(4) (a) (amount previously allowed as a deduction under section 12J(2)

The amount deemed to be of a capital nature under Section 9C (8th Schedule of the Income Tax Act) is equal to the amount received or accrued in excess of the amount recouped under section 8(4) (a), namely, R 500 000 (R900 000-R 400 000). This amount is subject to CGT.

[27] Example from SARS Draft Guide on Venture Capital Companies.

CGT

	R	R
Amount receive or accrued		900 000
Less: Amount recouped under section 8(4) (a) [paragraph35 (3)]		(400 000)
Proceeds		500 000
Less: Base Cost		
Cost	400 000	
Less: Deduction under section 12J (2) [paragraph 20(3) (a)	(400 000)	-
Capital Gain		500 000
Taxable capital gain (80% x R 500 000)		400 000

Mitigating the risks

An investor must understand the risks involved when investing in a Section 12J VCC. Venture capital by definition is capital invested in projects in which there is a substantial element of risk. Investors should seek the advice of an independent financial advisor specialising in section 12J investments and who can advise them on whether a particular section 12J investment is suitable for their investment portfolio.

SARS or the FSCA can withdraw a VCC's section 12 J status if it does not comply with all the legislative requirements and investors then might have to pay back the tax recoupment they received when making the Section 12J investment[28].

The last thing an investor wants to find out is that the Section 12J company in which he has invested has lost its Section 12J status due to regulatory non-compliance. Investors can mitigate the risks by asking the following questions:

- Has the VCC applied for and obtained a positive SARS ruling for its investment strategies?
- What tax opinions were obtained?
- Who is the companies' tax advisors?
- What systems were implemented to monitor tax-related compliance risk?

[28] Section12J6, 6A and Section12J(8)

The Future

National Treasury in the Budget review that was published in February 2019 noted that there has been significant growth in section 12J Investments over the past two years and that legislation would be amended to encourage further investment in these types of investments. Although the exact nature of the amendments is not yet known, Treasury's comments have been taken as a positive sign that section 12J investments may be extended beyond June 2021.

Conclusion

It is clear from the above that potential investors should be knowledgeable enough to understand the rewards and risks involved when investing in a section 12J investment. Tax breaks might be appealing, but a committed holistic long-term financial plan and investment strategy remains of key importance when advising clients.

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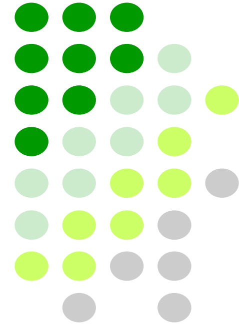

Retirement Planning

Implications of a Section 197 Transfer on Retirement Benefits

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Introduction

Employers who are in the process of selling or buying a business must take into account the provisions of section 197 of the Labour Relations Act[1]. This section deals with the rights and duties in respect of employees where the business is sold as a going concern or as part of a winding-up or sequestration transfer.[2]

Under the old Labour Relations Act 28 of 1956, an employer who wanted to sell his business was obliged to pay a severance payment to its employees as it terminated the employment contract. Under the new Labour Relations Act 66 of 1995 (LRA) the position is different. In terms of Section 197 of the LRA, the contracts of employment of the existing employees are automatically transferred to the new employer subject to the provisions of this section.[3]

Section 197 sets out the position of the transferred employees more clearly when a business is transferred to a new employer as well as the position and responsibilities of the old and new employer. In terms of section 197 the new employer is automatically substituted in the place of the old employer in respect of all contracts of employment in existence immediately before the transfer. The rights and obligations that existed between the old employer and each employee continue in force with the new employer and anything done before the transfer by or in relation to the old employer is deemed to have been done by the new employer (this includes but is not limited to dismissal, unfair discrimination or unfair labour practices). An employee's continuity of service is not interrupted by a section 197 transfer, therefore the years of service with the old employer must be taken into account when, for example, the employee's seniority in the company is determined and when the severance pay of the employee is determined where the employee is retrenched.[4]

This article will however focus on the two different approaches in the application of section 197 of the LRA to retirement benefits in a pension or provident fund. In terms of the one approach a more liberal interpretation of section 197 is followed than in the other.

[1] Labour Relations Act 127 of 1998
[2] Kobus Hanekom, Manual on retirement funding and other Employees Benefits Part 2, Chapter 16
[3] When a business is sold what happens to the employees: 2017. Available at http://www.businessessentials.co.za/2017/08/25/section197-business-sold [Accessed on 12 June 2019]
[4] Supra note 2

In terms of section 197 (2) *If a transfer of a business takes place, unless otherwise agreed in terms of subsection (6)-*

a) The new employer is automatically substituted in the place of the old employer in respect of all contracts of employment in existence immediately before the date of transfer;
b) All the rights and obligations between the old employer and an employee at the time of transfer continue in force as if they had been rights and obligations between the new employer and the employee
c) Anything done before the transfer by or in relation to the old employer, including the dismissal of an employee or the commission of an unfair labour practice or act of discrimination, is considered to have been done by or in relation to the new employer; and
d) The transfer does not interrupt an employee's continuity of employment, and an employee's contract of employment continues with the new employer as if with the old employer

The liberal approach

In this approach the transferring of a business is seen as completely separate from transferring the employees' pension rights. Despite section 197(2) (d) which stipulates that the transfer does not interrupt an employees' continuity of employment, it is still regarded by many as having terminated the employment contract with the old employer hence in terms of the employees' pension rights in the pension fund of the old employer participated, they are entitled to withdrawal benefits. In other words, the employees' may have access to withdraw their benefits in cash or transfer to an approved fund of their choice including a preservation fund.

In the case of the *Telkom Pension Fund v Blom & Others*[5] which went on appeal, Telkom and the Fund argued that the respondents contract of employment were kept alive as a result of section 197 transfer, that the posts were not abolished but rather preserved. Bertelsmann J made an order directing Telkom and the Fund to pay the respondents their retirement benefits in consequence of their former employment being terminated with Telkom. He was of the view that the fund is an independent entity distinct from the employer. It was not a party to the agreement between the old employer and the new employer. It could not be compelled to accept contributions from the new employer. Furthermore, the Fund may not transfer pension benefits without the approval of the member.

[5]Telkom SA Ltd and Others' v Blom and Others (227/02) [2003] ZASCA 67

In 2002 there was an amendment to section 197 (4) which now states that a transfer does not prevent an employee from being transferred to a pension fund, provident or retirement or similar fund other than the fund to which the employee belonged prior to the transfer[6]. Section 197(4) is permissive and not mandatory which seems to indicate that the legislature is aware of the difficulties relating to pension rights when contracts are transferred in terms of section 197[7].

In a case that came before the Pensions Fund Adjudicator Vuyani Ngalwana he upheld the case of five workers who wanted to be paid their fund benefits after their division was transferred to another subsidiary in the group. He was of the opinion that the contract of employment ended when part of *Imperial Distribution* was moved to *Fast n' Fresh.* The staff signed new employment contracts. Furthermore, the rules of the fund stipulated what happens when a contractual relationship between the employer and employee is terminated. In the latter case the members had a choice to receive the cash pay-out or to transfer to another fund. All members chose to receive the cash.

The stricter approach

The introduction of section 197(4) of the Labour Relations Act in 2002, made provision for affected employees to transfer their accumulated pension benefits into a scheme in which the transferee employer participates, or an alternative pension vehicle. The Income Tax Act specifically provides for membership, of employees who are members of a provident and /or pension fund and affected by a transfer of business in terms of section 197 of the LRA, to a preservation fund. However, this provision is permissive and not mandatory. In this way continuity of retirement provision can be preserved along with continuity of employment.

In the case of *Vawda vs Standard Bank Group Retirement Fund*[8] the issue for determination before the Pension Funds Adjudicator was whether or not the Complainant was entitled to his withdrawal benefits after the transfer of his contract of employment in terms of section 197. He as well as his financial consultant was of the view that he should be entitled to transfer his benefit to a preservation fund despite the latter not being one of the options provided by the fund. The only options provided were a transfer to the new employer's pension or provident fund or a transfer to a retirement annuity fund. According to the pension fund rules "no member may

[6] Moseki Maleka, 2003.Does your pension fund go with you? Juta's Business Law, volume ll, Issue 4, 234- 236
[7] Salt L, Joffe D, Pension funds and commercial transactions. Available at https://www.polity.org.za/article/pension-funds-commercial-transactions-2017-8-02 . [Accessed on 12 June2019]
[8] Vawda vs Standard Bank Group Retirement Fund [2010] 3 BPLR371 (PFA)

terminate his membership of the Fund while he remains in service…" The Adjudicator found that the Complainant was not entitled to a withdrawal benefit as he was still employed (in service) and the employment was never interrupted by the section 197 transfer. The Complainant's case was dismissed.

In the case of *Horn & Other vs LA Health Medical Scheme*[9] the appellants' instituted action against LA health and Cape Joint Municipal Pension Fund for an additional redundancy / retrenchment benefit provided for in the rules upon the termination of employment. LA Health was transferred as a "going concern" to Discovery.

Zondo J, was of the view that a transfer of business as a going concern neither terminates employment contracts nor is it a lawful reason for the termination of employment contracts and that all the rights and obligations existing between the business transferor and each employee prior to the transfer are retained[10] . Accordingly, Discovery took over the obligation that the employees sought to enforce against LA Health. The employees sued the wrong party and should have joined Discovery to their proceedings.

In terms of this approach, there is much focus on the continuity of employment after the transfer rather than considering it as a termination of an employment contract with the old employer.

Housing loans

Some retirement funds offer their members housing loans or have suretyship arrangements with financial institutions. Upon a section 197 transfer a member being transferred to a fund that does not offer these arrangements creates a problem. The new fund may not be able to take on this obligation and as soon as the benefits are transferred to the new fund the housing loan must be settled. In some cases, the member may retain their retirement benefit in the old fund as paid up. If members default in their repayment to the financial institution, the financial institution will request payment form the old fund in terms of the suretyship agreement. Many members see this as an opportunity to have their home loans settled by the old fund.

[9] Horn & Other vs LA Health Medical Scheme & Another (2015) ZACC 13
[10] Marhye N, 2015. Case law update. Momentum legal update 11-2015

Conclusion

It is important for financial advisors to tread cautiously when providing advice to clients about their retirement benefits in a section 197 scenario. In some cases, the most obvious option may not be an option at all. Much depends on the fund rules and whether a liberal or stricter approach is being taken.

A possible solution is to draft fund rules as well as employment contracts in such a manner that it makes provision for options specifically applicable to a transfer in terms of section 197. Trustees of the retirement funds should also be involved in the sales process with both the old and new employers.

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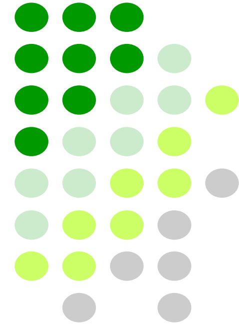

Retirement Planning

Taxation of Public Sector Funds

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Introduction

Where a member of a retirement fund's membership terminates, such a member becomes entitled to a lump sum benefit. The lump sum benefit is subject to income tax in the year it accrues to the member of the retirement fund. The taxation of lump sum benefits derived from a public sector fund may at times cause confusion within the financial planning industry. This may make it difficult for intermediaries to provide clients with appropriate advice when clients exit public sector funds. This article aims to explain how the tax on lump sums from public sector funds are calculated.

Public sector fund as defined

A "public sector fund"[1] means a fund referred to in paragraph (a), (b) of (d) (paragraph (d) is only effective form 1 March 2021) of the definition of "pension fund" and paragraph (b) or (c) of the definition of "provident fund" (it is submitted that paragraph (b) and (c) referred to in the definition of a "public sector fund" pertains to the amendments that have yet to be effected on 1 March 2021) in Section 1 (1) of the Income Tax Act[2]. The Government Employees Pension Fund (GEPF) and Transnet are examples of public sector funds.

Pre 1 March 1998 taxation of public sector fund

Tax on public sector funds were only introduced from 1 March 1998. Before 1 March 1998, lump sums payable from public sector funds were not taxable.

Where a member was a member of a public sector fund prior to 1 March 1998 and such member resigns or retires from the fund after 1 March 1998:

- A portion of the lump sum payable to the member is attributed to the completed years of employment prior to 1 March 1998, such portion will not be taxable; and
- A portion of the lump sum is attributed to the completed years of employment after 1 March 1998, which will be taxable.
- With this in mind, the taxable portion of the lump sum benefit has to be determined before the relevant tax table is applied.

Paragraph 2A of the Second Schedule[3] provides that where any lump sum benefit is received or accrues from a public sector fund, the amount to be included in the gross income of any person

[1] "Public sector fund" as defined in paragraph 1 of the Second Schedule to the Income Tax Act 58 of 1962

[2] 58 of 1962

[3] Income Tax Act 58 of 1962

shall be deemed to be an amount equal to the amount determined in accordance with the following formula:

A = B/C x D

In which formula,

- "A" represents the taxable portion of the lump sum to be determined, subject to further deductions allowed by paragraphs 5 and 6 of the Second Schedule in terms of the Income Tax Act.
- "B" represents the number of completed years of employment after 1 March 1998 or completed years of employment approved after 1 March 1998 during which the person had been a member of the Fund, including previous or other periods of service approved as pensionable service in terms of the rules of the Fund after 1 March 1998.
- "C" represents the total number of years taken into account for determining the benefits payable, or the number of completed years during which the person had been a member of the Fund.
- "D" represents the lump sum benefit payable to the person.

  The following examples illustrates how the tax is determined on a lump sum payable to a member from a public sector fund:

Taxation applicable to a public sector fund benefit upon retirement

Example 1:

Jane is a member of a defined benefit public sector pension fund. She has been a member of the fund as from 1 March 1980 and is retiring from the fund on 30 April 2020. The total retirement interest in the fund is R6 000 000. The rules of the fund allow the member to take a maximum of one third of the fund value as a lump sum on retirement. Jane decides to take her full one third of the fund value as a lump sum.

Use the formula in paragraph 2A of the Second Schedule to calculate the taxable and the tax-free portion of the lump sum:

A = B/C x D

A = Taxable portion

B = 22 (Number of **completed** years' service from 1 March 1998)

C = 40 (Total number of **completed** years' service)

D = R2 000 000

Apply the formula: 22/40 x R2 000 000 = R1 100 000

Therefore, the tax free portion is R900 000 (R2 000 000 – R1 100 000) and only R1 100 000 is subject to tax.

Apply tax using the retirement tax table:

Taxable income from lump sum benefit	Rate of tax
0 – R500 000	0%
R500 001 – R700 000	18% of the amount above R500 000
R700 001 – R1 050 000	R36 000 + 27% of the amount above R700 000
R1 050 001 and above	R130 500 + 36% of the amount above R1 050 000

Tax = R130 500 + 36% of (R1 100 000 – R1 050 000)
= R130 500 + 36% of R50 000
= R130 500 + R18 000
= R148 500

The member will pay tax of R148 500 on the lump sum benefit of R2 000 000.
It is important to note that only that part of a member's benefit that is taken as a lump sum at retirement is subject to the formula and not the member's total benefit.

Taxation applicable to a public sector fund on resignation

Where a member exits the fund as a result of a resignation from service, the member has two options available. The member can choose between receiving the full fund value as a cash resignation benefit or to transfer the full fund value to an approved retirement fund.

Should the member opt for a cash resignation benefit, such member will become entitled to a cash lump sum benefit calculated as per the provisions of rule 14.4.1(a) of the Government Employees Pension Law[4]. In this instance the paragraph 2A formula will be applied to the full resignation benefit.

[4] 1996

Using the facts from example 1, if Jane resigned from the fund and opted for a cash resignation the calculation will look as follows:

A = B/C x D

A = Taxable portion

B = 22 (Number of **completed** years' service from 1 March 1998)

C = 40 (Total number of **completed** years' service)

D = R6 000 000

Apply the formula: 22/40 x R6 000 000 = R3 300 000

Therefore, the tax free portion is R2 700 000 (R6 000 000 – R3 300 000) and only R3 300 000 is subject to tax.

Apply tax using the withdrawal tax table:

Taxable income from lump sum benefit	Rate of tax
0 – R25 000	0%
R25 001 – R660 000	18% of the amount above R25 000
R660 001 – R990 000	R114 000 + 27% of the amount above R660 000
R990 001 and above	R203 400 + 36% of the amount above R990 000

Tax = R203 400 + 36% of (R3 300 000 – R990 000)

= R203 400 + 36% of R2 310 000

= R203 400 + R831 600

= R1 035 000

Jane will pay tax of R1 035 000 on the lump sum benefit of R6 000 000.

The second option available to the member is to transfer the full resignation benefit to an approved fund. Again the paragraph 2A formula is applied to the full resignation benefit in order to determine the pre-1 March 1998 tax-free portion that will be allowed as a deduction when the member retires from the approved fund. Refer to examples 3 and 4 below for a detailed illustration of taxation after the preservation of the member's fund benefits.

The reverse method

When advising a client on whether to take a lump sum benefit or not, it is important to know what the maximum lump sum amount is that the client will be able to receive without paying any tax thereon. In this instance we will apply the so-called "reverse formula" to establish the answer. This formula is applicable if the client has a pre-1 March 1998 portion and 0% tax rate is also applicable. Please note that the "reverse formula" is not a formula prescribed in the Income Tax Act, but merely a method to establish the maximum lump sum to be taken if there is both a pre-1 March 1998 tax-free portion and an amount left in respect of the 0% tax rate. Let's illustrate this with an example:

Example 2:

Trevor retires from the Transnet Retirement Fund. He became a member of the Transnet retirement Fund on 1 March 1987 and resigned on 30 November 2019. He thus has a total of 32 years completed service with the government, of which 21 completed years are post 1 March 1998. He has not previously received any lump sums from retirement funds or any severance benefits. Trevor would like to know what the maximum lump sum amount is that he will be able to receive without paying any tax on the lump sum.

- Apply the reverse formula to determine the maximum lump sum amount:

  A (Maximum lump sum amount to be determined) = C (total completed years of service) ÷ B (completed years of service after 1 March 1998) x D (the total amount left to be taxed at 0% on retirement)

  A = 32/21 x R500 000
  = R761 904.76

  Let's test the answer with the prescribed formula:

  A = B/C x D
  = 21/32 x R761 904.76
  = R500 000 (taxable amount)
  R500 000 taxed at 0% (no prior retirement or withdrawal lump sums or severance benefits)
  = R0 tax payable.

By applying the reverse formula, we were able to determine that Trevor may take R761 904.76 without having to pay tax thereon. It is important to note that the lump sum will be limited to what the fund rules allow.

If Trevor took a lump sum from a retirement fund (withdrawal on or after 1 March 2009 or on retirement on or after 1 October 2007 or received a severance benefit on or after 1 March 2001) in the amount of R200 000 it would mean that he had used R200 000 of his 0% tax rate applicable to retirement and would thus have R300 000 (R500 000 – R200 000) left to be taxed at 0%. Taking this into account, the calculation would look as follows:

32 (total years of service) ÷ 21 (completed years of service post 1 March 1998) x R300 000 (amount left to be taxed at 0%)

= R457 142.86

In this instance, Trevor may take R457 142.86 without having to pay tax thereon.

Preservation of the pre 1 March 1998 portion

Rule 14.4.1 (b) of the GEPF allows for the transfer of a resignation benefit to an approved retirement fund. Before the amendment of Rule 14.4.1 of the GEPF, a member's resignation benefit was taxed and regarded as after-tax money. Therefore, a member of the GEPF could not transfer their resignation benefit to a pension preservation fund because preservation funds may only receive transfers and the after-tax money would be viewed as a contribution to the preservation fund which is not allowed. GEPF members were still able to transfer to a retirement annuity fund.

Paragraphs 5 (retirement benefits) and 6 (withdrawal benefits) of the Second Schedule set out what amount should be deducted from the lump sum benefit before the tax tables are applied. Before 1 March 2006 the deduction for the tax-free portion in respect of pre-1 March 1998 service was not allowed when the member transferred to an approved retirement fund.

Section 52 of the Taxation Laws Amendments Act[5] amended paragraph 6 of the Second Schedule to provide that tax-free portion in respect of pre-1 March 1998 service would be allowed as a deduction before the tax on a withdrawal benefit is calculated when the member transferred to a pension fund, provident fund or retirement annuity fund from 1 March 2006.

[5] 08 of 2007

Section 62 of the Taxation Laws Amendments Act[6] expanded these deductions to apply to transfers to pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund as defined by section 84 of the Taxation Laws Amendment Act[7]. The amendment applied to benefits transferred on or after 1 March 2009.

Section 61 of the Taxation Laws Amendments Act[8] amended paragraph 5 of the Second Schedule and provided that if a member transfers the benefit from a public sector fund to a pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund, the tax-free amount calculated under the formula in paragraph 2A of the Second Schedule qualifies as a deduction before tax on retirement on the first transfer from the public sector fund after 1 March 2009.

Effective 1 March 2018 the deduction is carried forward for two transfers.[9] This means that if a member transfers the full fund value from a public sector fund to another approved fund, the tax-free amount is calculated on that transfer and will serve as a deduction when the member retires from such approved fund. Should the member wish to not retire from this approved fund but rather transfer the benefits to a second approved fund, the tax-free portion will still serve as a deduction against lump sums accruing at withdrawal, retirement or death. The deduction of the pre-1 March 1998 tax-free portion is forfeited if the member does a third transfer to another retirement fund.[10]

Example 3:

Continuing with the facts from example 1, Jane transfers the R6 000 000 to a retirement annuity fund and retires years later where the total benefit in the fund is R9 000 000. In this instance, the tax free amount, as calculated before the benefit was transferred to the retirement annuity, must first be deducted before the tax payable is calculated. As this is a retirement annuity, the member is only allowed to take one third as a lump sum.

[6] 17 of 2009
[7] 07 of 2010
[8] 17 of 2009
[9] Section 63(1)(b) of The Taxation Laws Amendment Act 17 of 2017
[10] It is further important to note that it is the view of SARS that in order to preserve the pre-1 March 1998 portion on such subsequent (2nd) transfer, both the 2nd transfer and the accrual of the lump sum (i.e. on withdrawal/retirement/death) had to take place on or after 1 March 2018. Where a member had thus made the second transfer before 1 March 2018 but decides to withdraw a lump sum or retire and receive a lump sum on or after 1 March 2018, the deduction in respect of the pre-1 March 1998 tax-free portion will not be available to him/her

To determine the tax payable on the lump sum, one has to calculate what the pre-1 March 1998 tax-free portion is:

- Apply the paragraph 2A formula to the total benefit before the transfer to the retirement annuity to determine the taxable portion:
  22/40 x R6 000 000 = R3 300 000
- Calculate the pre-1 March 1998 tax-free portion:
  R6 000 000 – R3 300 000 = R2 700 000
- Deduct the tax-free portion from the lump sum the member is taking:
  R3 000 000 – R2 700 000 = R300 000

Therefore, the amount that would be taxed on the retirement tax table is R300 000. There would be no tax payable as the first R500 000 is taxed at 0%.[11] This will also be the case had the benefit been transferred to a pension preservation fund.

To best illustrate the taxation of a public sector fund, here follows a practical example:

Example 4:

Leslie became a member to the Government Employees Pension Fund (GEPF) on 1 June 1980. On 1 June 2017 Leslie resigns from the GEPF with a resignation benefit of R5 000 000. Leslie decides to transfer her benefit to an Old Mutual pension preservation fund. On 1 March 2019, Leslie retires from the pension preservation fund which has a fund value of R9 000 000. As Leslie's financial adviser, you advise her to take one third as a lump sum in order for her to settle her liabilities and purchase an annuity with the remaining two thirds. Leslie wants to know how her lump sum will be taxed. She advises you that she has not made any previous withdrawal from a retirement fund and also has no other allowable deductions. The following steps must be followed in order to calculate the tax payable on the retirement lump sum:

Step 1: Determine the tax free portion of the lump sum benefit when Leslie transferred the benefit to the pension preservation fund, since Leslie was a member of the public sector fund before 1 March 1998, by using the following formula:

A = B/C × D

A = (1 March 1998 – 1 June 2017) / (1 June 1980 – 1 June 2017) x R5 000 000

A = 19 / 37 × R5 000 000

A = R2 567 567, 57

The tax free portion is therefore: R5 000 000 – R 2 567 567, 57 = R2 432 432, 43

[11] Other allowable deductions and previous withdrawals were not taken into account.

Step 2: Determine the total taxable income in respect of all lump sums received or accrued (including the current lump sum benefit):

Current retirement fund lump sum benefit (one third of R9 000 000)	R3 000 000
All retirement fund lump sum withdrawal benefits (on or after1 March 2009)	0
All retirement fund lump sum benefits (on or after 1 October 2007)	0
All severance benefits (on or after 1 March 2011)	0
Less: Excess fund contributions	0
Less: Tax free portion from public sector funds	(R2 432 432)
Total taxable income	R567 568

Step 3: Apply the rate of tax applicable to the total lump sum amount calculated in Step 2:

Taxable income from lump sum benefit	Rate of tax
0 – R500 000	0%
R500 001 – R700 000	18% of the amount above R500 000
R700 001 – R1 050 000	R36 000 + 27% of the amount above R700 000
R1 050 001 and above	R130 500 + 36% of the amount above R1 050 000

Tax = 18% of (R567 568 – R500 000)
= 18% of R67 568
= R12 162, 24

Leslie will pay tax of R12 162,24 on the lump sum benefit of R3 000 000.

Section 10C Income Tax Act

Paragraph 5 and 6 of the Second Schedule to the Income Tax Act provides that previously disallowed contributions to retirement funds can be offset against retirement lump sums at retirement. Section 10C of this Act further provides where such deduction has not been set off against a lump sum taken, it may be deducted against the income from the compulsory annuity purchased (excluding annuities purchased with funds from provident and provident preservation funds) with the fund proceeds at retirement. However, this only refers to amounts transferred from a public sector fund to another approved fund and not to contributions made by an individual to an approved pension fund or retirement annuity fund under section 11F of the Income Tax Act. Thus, where the client retires from the public sector fund and is not able to use the full pre-1 March

1998 portion, the general view is that the balance of this tax-free portion may not be used as a deduction against lump sums from other funds and it is not allowed as a deduction against annuity income in terms of section 10C of the Income Tax Act.

The impact of divorce on a public sector benefit

When a member divorces, his or her spouse may be entitled to a portion of the member's pension interest in terms of the divorce order granted by the court. The percentage that the non-member former spouse is entitled to is calculated based on the provisions of the divorce order, or the settlement agreement which has been made an order of the court.

If a divorce order grants a non-member former spouse a share of the pension interest, that non-member former spouse can choose to either receive their share in cash, or have it transferred to an approved retirement fund. If the non-member former spouse chooses to take their share in cash, the non-member former spouse will be liable for the tax on the pension interest.

The pre-1 March 1998 tax-free lump sum calculated in terms of paragraph 2A of the Second Schedule of the Income Tax Act will be apportioned between the spouses on divorce. The non-member former spouse retains this tax-free amount irrespective of whether he or she elects to commute or transfer his or her share of the pension fund to an approved fund.

Example 5:

John became a member of the GEPF in February 1990. The value of his pension interest on date of divorce was R2 000 000. Sue was awarded 40% of the interest (R800 000). Sue elects to take the whole award in cash in March 2016.

Apply the Paragraph 2A formula to Sue's award: 18 (competed years after 1 March 1998)/26 (total completed years of service on date of election) x R800,000 = R553 846 (taxable portion of lump sum).

Therefore, R553 846 will be taxed according to the Retirement Fund Lump sum withdrawal table:

= 18% of the amount above R25 000

= 18% of R528 846

= R95 192.31.

She will thus receive an amount of R704 807.69 nett of tax.

Divorce debt

On 23 May 2019 the GEPF amended the rules with regards to what happens to the member's pension interest after a divorce. Before the amendment, on the date of accrual and payment of a divorce benefit, the fund created a debt against the member for the amount payable to the former spouse. This is called "divorce debt". The divorce debt amount gathers interest until the member leaves the Fund. The member must repay this amount in a lump sum, or in instalments. Any remaining divorce debt will be deducted from the member's benefits on exit.

The amendment has removed the pension debt that accrued to the GEPF member when a portion of their pension was paid out by the GEPF as a divorce settlement and now ensures that rather than creating a debt, there will be an adjustment to the member's pensionable service following the payment of a divorce settlement by the GEPF. This means that the benefit that will be paid to the member upon retirement will now be decreased by reducing the member's years of pensionable service to take into account the pension interest of the member that was given to the spouse upon divorce.[12]

The new rules came into effect on 1 August 2019. The GEPF is allowing all affected members the opportunity to opt from the old divorce debt model into the service reduction model. The affected members will have up until the 22 May 2020 to indicate their choice. Affected members who fail to indicate their choice by this date will automatically be converted into the new approach.

Conclusion

Financial advisers should familiarise themselves with the rules of the relevant public sector fund, and should be aware of the specific facts relating to their clients' tax status. The following points should be at the top of the financial adviser's list when dealing with a client who wants to resign or retire from a public sector fund:

- ❑ Has the client made any previous withdrawals from retirement funds?
- ❑ When determining the tax-free amount, the formula is only applied to the lump sum that the member takes and not to the member's total benefit.
- ❑ If a member resigns from the fund, irrespective of whether the member takes the benefit as a lump sum or transfers it to another approved fund, the formula is applied to the full resignation benefit.

[12] Rule 14.10.9 of the Government Employees Pension Law

- The tax-free portion is only allowed as a deduction on the first and second transfer out of the public sector fund and the deduction will not be available on a third transfer.
- Where the client retires from the public sector fund and is not able to use the full pre-1 March 1998 portion, the balance of this tax-free portion may not be used as a deduction against lump sums from other funds and it is not allowed as a deduction against annuity income.
- Where a portion of a member's pension interest has been awarded to their former spouse due to a divorce, it is important to take this into account when doing the client's retirement planning.

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Divorce & Retirement Benefits

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Introduction

It is well known that divorce is one of the most stressful life events a person can experience. Even in an amicable divorce there are many practical and legal issues to consider. This article aims to provide some clarity and guidance on how to deal with both pre- and post-retirement benefits.

1. Marital regimes

An article on divorce would be incomplete if we did not explore the various marital regimes applicable in South Africa. These marital regimes are:

(i) Marriages in community of property

(ii) Marriages out of community of property:

- (a) With the inclusion of the accrual system; or
- (b) With the exclusion of the accrual system.

1.1 Marriages in community of property:

If the spouses do not conclude an ante-nuptial contract, the marriage will automatically be in community of property. This means that the assets of each spouse as at date of marriage and assets acquired during the subsistence of the marriage will form part of one joint estate where each spouse owns an undivided half share, with certain exceptions.

The assets which are excluded from the joint estate are:

- Inheritances or donations excluded by will or deed of donation. This exclusion extends to the replacement of these assets e.g. where a spouse inherits immovable property and sells it, the proceeds would be excluded from the joint estate. It is important to note that the fruits i.e. income of the asset will not be excluded from the joint estate unless expressly excluded in the will or deed of donation.[1]
- Assets excluded in an ante-nuptial contract even though the parties are married in community of property.
- Property subject to a limited interest such as a fiduciary or usufructuary interest.[2]
- Any amount recovered by a spouse for damages, other than damages for a patrimonial loss by reason of a delict committed against that spouse, for example: a spouse is involved in a motor vehicle collision and is successful in a law suit and receives damages for the repair of her motor vehicle and hospital bills as well as an amount for pain and suffering. The amount

[1] S10.42 Silke on Income Tax
[22] Hahlo HR 165

paid for the repair of the motor vehicle and hospital bills will form part of the joint estate as these amount to a patrimonial loss i.e. a financial loss. The compensation for pain and suffering would however constitute a non-patrimonial loss and thus be excluded from the joint estate.[3]

All liabilities and debt entered into by either spouse before the marriage as well as debt incurred during the subsistence of the marriage will form part of the joint estate.

1.2 Marriages out of community of property with the inclusion of the accrual system

If a marriage is out of community of property entered into after 1 November 1984, the accrual system will automatically apply to such marriage, unless it is expressly excluded.[4] In terms of the accrual system, during the subsistence of the marriage the spouses retain their separate estates and are able to deal with it independently. The spouses do not have joint responsibility for any debts or liabilities. It is only upon the dissolution of the marriage that the wealth acquired during the marriage is shared.

The spouse with the smaller accrual has a claim for an amount equal to half the difference between the two accruals. The accrual in each spouse's estate is the amount by which the net value at dissolution of the marriage exceeds the net value at commencement of the marriage.

Certain assets are excluded from the accrual:

- Assets excluded in the ante-nuptial contract as well as the replacements of such excluded assets.[5]
- Donations between spouses.[6]
- Any inheritance or donation which accrues to a spouse during the subsistence of the marriage, unless it is expressly included via the ante-nuptial contract of the spouses.[7]
- Any damages, other than damages for a patrimonial loss, accruing to a spouse.[8]

1.3 Marriages out of community of property without the accrual system:

Each spouse retains full ownership over any assets owned at the time of the marriage as well as during the subsistence thereof. Liabilities and debts are not shared between the spouses.

[3] Section 18 Matrimonial Property Act 88 of 1984
[4] Section2 of the Matrimonial Property Act 88 of 1984
[5] Section 4(1)(a)(ii) of the Matrimonial Property Act 88 of 1984
[6] Section 5(2) of the Matrimonial Property Act 88 of 1984
[7] Section 5(1) of the Matrimonial Property Act 88 of 1984
[8] Section 4(1)(b)(i) of the Matrimonial Property Act 88 of 1984

2. Pension Benefits

2.1 Marital regimes and pension interest

2.1.1 Marriages in community of property:

Pension interest will form part of the joint estate of the spouses for divorce purposes.[9]

2.1.2 Marriages out of community of property with the inclusion of the accrual system:

Pension interest will form part of the estates of both spouses for purposes of divorce and will be taken into account in the calculation of the accrual.[10]

2.1.3 Marriages out of community of property without the accrual system

(i) Before 1 November 1984:

The spouses retain their own separate estates unless a court of law orders a redistribution of assets in terms of the Divorce Act[11]. Pension interest will form part of the spouses' estates and will form part of the assets if redistribution is ordered. The parties may of course agree to the division of the pension interest.

(ii) After 1 November 1984

The spouses retain their own separate estates. Pension interest is however not considered to be part of the spouses' estates[12], even if a court orders the redistribution of the assets. T. This principles was confirmed in the matter of *Page v Municipal Gratuity Fund and Sanlam Life Insurance Limited*: the Pension Funds Adjudicator found that in terms of section 7(7) read with section 7(8) of the Divorce Act, in the case of a marriage concluded after 1 November 1984 and subject to an ante-nuptial contract which excludes community of property, community of profit and loss as well as the accrual system, a divorce order, in terms of which a non-member spouse is awarded a portion of the member spouse's pension interest and the retirement fund is ordered to make payment to the non-member spouse, is not enforceable[13].

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[9] Section 7(7) of the Divorce Act 70 of 1979

[10] Section 7(7) of the Divorce Act 70 of 1979

[11] Section 7(3) of the Divorce Act 70 of 1979

[12] Section 7(7)(c) of the Divorce Act 70 of 1979

[13] Marriages out of community of property (accrual excluded): *Page v Municipal Gratuity Fund, Carien* Veenstra, *Insurance and Tax, Volume 34, 1 March 2019*

2.2 Divorce Order

The Divorce Order must contain:

(i) A specific reference to "pension interest".

(ii) The following references will not be binding: "pension fund", "pension benefits", "joint estate", or "proceeds of the policy"

(iii) The name of the fund.

Where the fund is not named, it should be possible to ascertain from the wording of the order which fund was being referred to. For example, "the member's employer fund" would possibly be ascertainable but the reference to "Old Mutual retirement annuity fund" would not be acceptable as Old Mutual has more than one fund.

(iv) A specified percentage or amount of the pension interest.

It must be clear how much of the member's pension interest has been assigned to the spouse. The following is likely not to be binding: "the pension must be divided equally" or "any debt incurred by the non-member spouse must be deducted from the pension interest".

Retirement annuity fund

The following is an example of a compliant settlement agreement to a divorce order dealing with the endorsement of "pension interest" on the retirement annuity policies of the member spouse[14]:

"1. It is recorded that the Defendant/Plaintiff is a member of the …………… (note: the name of the fund should be specified), and that his/her benefits under the Fund are funded by the below-mentioned policies issued to the Fund by ……………. Assurance Company Limited. The policy numbers are:

a. ……………………

b. ……………………..

2. The Defendant/Plaintiff agrees that the Defendant/Plaintiff is entitled to ….% (note: specify percentage of pension interest as agreed upon between the two spouses) of the pension interest in the abovementioned policies as set at the date of divorce, as contemplated in Section 1 of the Divorce Act of 1979, as amended.

3. The Defendant/Plaintiff further agrees that the said …. % pension interest in the abovementioned policies to which the Defendant/Plaintiff is entitled to shall be paid by the ………………… Retirement Annuity Fund directly to the Defendant/Plaintiff or transferred to an

[14] Example drafted by OMEM CST Legal, undated

approved Fund in accordance with Section 37D(4) of the Pension Funds Act of 1956, as amended.

4. *Accordingly it is ordered that the endorsement be made in the records of the …………. Retirement Annuity Fund that ……… % of the said pension interest accrues to the Defendant/Plaintiff."*

If the parties fail to provide the Fund with a compliant divorce order, the fund will not be able to make payment to the non-member spouse and the fund will have to retire the member from the retirement annuity upon maturity and receipt of the instruction from the member spouse, as there is no valid divorce order against the fund. In such an instance, the non-member spouse would have to approach the courts for an amendment of the divorce order to comply with the legislative provisions, as the Fund cannot unduly withhold payment of the member's retirement benefit.

Pension, provident and preservation funds

The Pension Lawyers Association[15] utilise the following templates for the assignment of pension interest in respect of a pension, provident or preservation fund in divorce matters:

(a) Particulars of claim to summons for divorce proceedings

Particulars of Claim:

1. *The defendant is a member of the XYZ Pension Fund ('the fund').*
2. *In terms of Section 7(7) of the Divorce Act 70 of 1979 the defendant's pension interest as defined in Section 1 of that Act is deemed to be an asset in his estate. (Note: if the fund is a preservation fund then it should read "as defined in section 37D(6) of the Pension Funds Act 24 of 1956". Note also that the pension interest will be an asset in the joint estate if married in community of property).*
3. *The plaintiff requests an order directing that …. % (Note: or a specified rand amount) of the defendant's pension interest be assigned to her, and that the fund be directed to endorse its records to reflect her entitlement, pending payment of transfer of her assigned portion of the pension interest in terms of the provisions of section 37D(4) of the Pension Funds Act.*

[15] http://www.pensionlawyers.co.za/wp-content/uploads/2018/10/PLATemplateForDivorceOrdersWithPensionInterest.pdf accessed on 26 August 2019.

(b) Consent paper/settlement agreement to divorce order

Consent Paper:

1. *The parties record that the defendant is a member of the XYZ Pension Fund ("the fund").*
2. *The parties agree that the plaintiff shall be entitled to … % of the defendant's pension interest in the fund as defined in section 1 of the Divorce Act 70 of 1979. (Note: if the fund is a preservation fund then it should read "as defined in section 37D(6) of the Pension Funds Act 24 of 1956")*
3. *The parties further agree that the fund be directed to endorse its records to reflect the plaintiff's entitlement pending payment or transfer to the plaintiff of her assigned portion of the pension interest in terms of the provisions of section 37D(4) of the Pension Funds Act 24 of 1956.*

(c) Court order where there is no consent/settlement

Draft order where there is no consent paper:

1. *The plaintiff is awarded … % of the defendant's pension interest in the XYZ Pension Fund as defined in section 1 of the Divorce Act 70 of 1979. (Note: if the fund is a preservation fund then it should read "as defined in section 37D(6) of the Pension Funds Act 24 of 1956")*
2. *The XYZ Pension Fund is hereby directed to endorse its records to reflect the plaintiff's entitlement pending payment or transfer to the plaintiff of her allocated portion of the pension interest in terms of the provisions of section 37D(4) of the Pension Funds Act 24 of 1956.*

In the matter of Old Mutual Life Assurance Company (SA) Ltd and Sanlam Life Insurance Ltd v Swemmer[16], the Supreme Court of Appeal ruled that a divorce order which was in conflict with Section 7(7) and 7(8) read with Section 37A[17] and could not be enforced against the Funds. "The facts were that the lower court ordered, as part of the divorce order, that two retirement annuity policies were to be awarded to the non-member spouse (Mrs Swemmer) as "exclusive property". The Supreme Court of Appeal held that "if a court orders that a spouse is to forfeit certain benefits of a marriage, the court may order that 100% of the "pension interest" may be forfeited in favour of the non-member spouse. This court case clearly indicates the importance of ensuring that your divorce order contains a specific reference to a percentage of pension interest.

[16] (2004) 4 BPLR 5581 SCA
[17] Pension Funds Act 24 of 1956

2.3 What if the divorce order is silent on the issue of pension interest in respect of the division of the joint estate where the parties were married in community of property?

We have now already ascertained that, dependant on the marital regime, a spouse would have a claim to the pension interest of the other spouse. We have also seen that it is crucial that notwithstanding this entitlement, the divorce order has to make specific reference to the portion of such interest which the spouse would be entitled to. What happens then if the divorce order is silent on the issue of pension interest?

In the Supreme Court of Appeal matter of Ndaba v Ndaba[18], the parties were married in community of property and in their divorce order failed to deal specifically with the division of pension interest. The court held that the non-member spouse was still entitled to claim a portion of pension interest. Please note that this judgment does not mean that the registered pension fund would be entitled to make payment on the basis of a divorce order which is silent on the issue of pension interest. It merely means that the non-member spouse retains the right to claim pension interest, but would have to approach the court for an amendment of the order so that the wording complies with the provisions of the Divorce Act[19].

2.4 The definition of pension interest

The definition of pension interest in section 1 of the Divorce Act[20] differs in relation to retirement annuity funds as opposed to pension funds, provident funds and preservation funds):

"Pension interest"

In relation to a party to a divorce action who -

(a) *Is a member of a pension fund (excluding a retirement annuity fund), means the benefits to which that party as such a member would have been entitled in terms of the rules of that fund if his membership of the fund would have been terminated on the date of divorce on account of his resignation from his office;*

(b) *Is a member of a retirement annuity fund which was bona fide established for the purpose of providing life annuities for the members of the fund, and which is a pension fund, means the total amount of that party's contributions to the fund up to the date of divorce, together with a total amount of annual simple interest on those contributions up to that date, calculated at the same rate as the rate prescribed as at that date by the Minister of Justice* in terms

[18] (600/2015) ZASCA 162 2017(1)

[19] 70 of 1979

[20] Refer footnote 18

of section 1 (2) of the Prescribed Rate of Interest Act, 1975 (Act No. 55 of 1975), for the purposes of that Act.

Section 37D(5) of the Pension Funds Act[21] further qualifies the term "*pension interest*" in relation to a retirement annuity fund as follows:

(5) Despite paragraph (b) of the definition of "pension interest" in section 1 (1) of the Divorce Act, 1979, the total amount of annual simple interest payable in terms of the definition may not exceed the fund return on the pension interest assigned to the non-member spouse in terms of a decree granted in terms of section 7(8)(a) of the Divorce Act, 1979.

With regards to the pension interest in a preservation fund, section 37D(6) of the Pension Funds Act[22] provides as follows:

(6) Despite paragraph (b) of the definition of "pension interest" in section 1 (1) of the Divorce Act, 1979 (Act No. 70 of 1979), the portion of the pension interest of a member or a deferred pensioner of a pension preservation fund or provident preservation fund, that is assigned to a non-member spouse, refers to the equivalent portion of the benefits to which that member would have been entitled to in terms of the rules of the fund if his or her membership of the fund terminated, or the member or the deferred pensioner retired on the date on which the decree was granted.

From the above it is thus clear that there is a distinct difference in calculating the value of the pension interest for divorce purposes:

(a) In *the* case of a spouse being a member of a retirement annuity fund, the value of the pension interest will be the lower of premiums paid plus simple interest at the rate prescribed by the Minister in terms of the Prescribed Rate of Interest Act or premiums plus fund return. The value of the pension interest is determined at date of divorce[23]. The calculation of "premiums paid plus simple interest at the rate prescribed by the Minister in terms of the Prescribed Rate of Interest Act" usually requires an actuarial calculation.

[21] 24 of 1956
[22] Refer footnote 20
[23] Paragraph (b) of the definition of "pension interest" in section 1 of the Divorce Act read with section 37D(5) of the Pension Funds Act.

(b) In the case of a spouse being a member of a pension, provident or preservation fund the pension interest is essentially the amount that the member would have been entitled to on exit from the fund if his/her membership was terminated on date of divorce[24].

In respect of a pension interest in a retirement annuity fund awarded to a non-member spouse, the prescribed rate of interest is thus important when calculating the value of such pension interest.

2.5 Prescribed rate of interest[25]

Prior to 8 January 2016, the prescribed rate of interest was determined by the Minister of Justice in the Government Gazette.

From 8 January 2016, the interest rate is determined by the repurchase ("repo") rate determined by the South African Reserve Bank, plus 3.5% per annum. The Minister of Justice and Correctional Services must publish the prescribed rate of interest notice in the Government Gazette. The effective date of any changes to the repurchase rate is the 1st day of the 2nd month following the month in which the change of the repurchase rate is made.

The applicable interest rate which must be used when calculating the pension interest value of the retirement annuities on divorce depends on the date at which the divorce order was granted.

Date of divorce from 1 September 2019 until the next amendment of the repurchase rate:

- ❑ Repurchase rate 6.5%
- ❑ Interest rate 6.5% + 3.5% = 10%

Date of divorce from 1 January 2018 to 31 August 2019:

- ❑ Repurchase rate 6.75%
- ❑ Interest rate 6.75% + 3.5% = 10.25%

[24] Paragraph (a) of the definition of "pension interest" in section 1 of the Divorce Act and section 37D(6) of the Pension Funds Act.

[25] Old Mutual Hotline 18/2018

Date of divorce from 1 May 2018 to 31 December 2018:

- Repurchase rate 6.5%
- Interest rate 6.5% + 3.5% = 10%

Date of divorce from 1 September 2017 to 30 April 2018:

- Repurchase rate 6.75%
- Interest rate 6.75% + 3.5% = 10.25%

Date of divorce from 1 May 2016 to 31 August 2017:

- Repurchase rate 7%
- Interest rate 7% + 3.5% = 10.5%

Date of divorce from 1 March 2016 to 30 April 2016:

- Repurchase rate 6.75%
- Interest rate 6.75% + 3.5% = 10.25%

Date of divorce from 1 August 2014 to 29 February 2016:

- Interest rate 9%

Date of divorce prior to 1 August 2014:

- Interest rate 15.5%

2.6 Interest on Pension Interest

Is it possible to make provision for interest on pension interest? In a recent Financial Services Tribunal matter of Theodorus Swart v Pension Funds Adjudicator and ABSA Pension Preservation Fund[26], this very question had to be decided upon. In this matter the Applicant contended that his ex-spouse had deliberately caused a delay in the divorce proceedings. The Tribunal held that the Pension Funds Adjudicator was correct in concluding that the non-member spouse is only entitled to the interest on the fund return from the date of election until payment or transfer of the benefit. The Tribunal found:

[26] Case No: PFA1/2019; https://www.moonstone.co.za/upmedia/uploads/library/Moonstone%20Library/MS%20Industry%20News/Decision%20-%20Theodorus%20Swart%20%20v%20PFA%20and%20ABSA%20Pension%20Preservation%20Fund.pdf accessed on 27 August 2019

"It is our view that the provision of the Pension Funds (sic) Act and the Divorce Act do not provide for any other factor, such as delay in finalising divorce proceedings, to be considered in calculating return or growth on a portion of pension interest due to the non-member spouse. Section 37D(4)(c)(ii) of the Act, in our view, provides guidance on when does the accrual or return on the portion of pension interest of the non-member spouse occur."

The Pension Lawyers Association have states the following in its "Templates For The Assignment Of Pension Interest In Divorce Matters"[27]:

"It is not competent to award interest on the pension interest allocated to the non-member spouse as this is statutorily regulated by section 37D(4), which provides for growth on the allocated portion. This only commences running several months after the date of divorce, if the assigned pension interest is not paid over within the statutorily prescribed time limits.

Allocations which exceed the amount of the pension interest will not be enforceable against the fund, but may found claims inter partes."

2.7 Clean Break Principle

On 13 September 2007 the "clean break" principle was introduced by the Pension Funds Amendment Act[28] whereby payment may be made to the non-member spouse immediately after divorce. Prior to the introduction of this "clean break" principle, the relevant fund would endorse the records of the fund but the non-member spouse would have had to wait until the member exited the fund to receive any amount due to him/her.

The Government Employee Pension Fund (GEPF) is not subject to the Pension Funds Act and therefore it was not impacted by the introduction of the clean break principle under the Pension Funds Act in 2007. While this article does not purport to cover the GEPF, it is important to note that the GEPF law and rules were only amended on 14 December 2011 to allow the clean break principle. The GEPF Rules contain another anomaly in the form of "divorce debt".

[27] http://www.pensionlawyers.co.za/wp-content/uploads/2018/10/PLATemplateForDivorceOrdersWithPensionInterest.pdf page 3, accessed 1 August 2019

[28] 11 of 2007

The term "divorce debt", prior to its amendment, was defined as follows in Rule 1 of the GEPF Rules:

"divorce debt" in relation to a member means an amount equivalent to the amount of the pension interest assigned to the member's former spouse in terms of a divorce order or decree of dissolution of marriage accumulated from the date of payment to the former spouse to the date on which a benefit is paid to the member in terms of the rules together with the interest from the date of payment to the former spouse at the rate or rates determined from time to time by the Board as the rate or rates of interest payable in respect of monies owed to the Fund;"

Effectively this meant that where pension interest was awarded in a divorce order to a non-member spouse, the lump sum (gratuity) of the member spouse was reduced by the divorce debt (amount paid to non-member spouse plus interest from date of divorce until the member exits the GEPF plus interest thereon) and where there are not sufficient funds as far as the gratuity is concerned, it is deducted from the annuity.

This concept of "divorce debt" was challenged in the High Court matter of Crafford vs Government Employee Pension Fund and Others[29]. The applicant contended that the "divorce debt" approach which results in a "forced loan" infringes upon her constitutional rights to equality and social security and that it placed an unjustifiable burden on members of the GEPF.

The Financial Matters Amendment Act[30] has now substituted the "divorce debt" approach with the reduction of the member's years of pensionable service. Section 12 & 13 of the Financial Matters Amendment Act provides as follows:

Amendment of section 24A of Government Employees Pension Law, 1996, as inserted by section 3 of Act 19 of 2011

12. Section 24A of the Government Employees Pension Law, 1996, is hereby amended by the substitution in subsection (2) for paragraph (d) of the following paragraph:

''(d)(i) The benefit that is subsequently payable to the member shall, as provided in the rules, be decreased by reducing the member's years of pensionable service to take into account the pension interest of the member which was assigned to any former spouse of the member.

[29] Insert citation
[30] 18 of 2019

(ii) The rules referred to in subparagraph (i) shall be made on the advice of an actuary.''.

Transitional measure applicable to Government Employees Pension Law, 1996

13.(1) If the amount of the pension benefit payable to a member is subject to reduction contemplated in section 24A(2)(d) of the Government Employees Pension Law, 1996, ***before its amendment by section 12 of this Act, the member shall, within 12 months after the commencement of this section****, in writing notify the Fund whether the reduction shall be dealt with in terms of section 24A(2)(d) of the Government Employees Pension Law, 1996—*

(a) before its amendment by section 12 of this Act; or

(b) as amended by section 12 of this Act.

(2) If a member does not notify the Fund as required by subsection (1), the reduction shall be dealt with in terms of section 24A(2)(d) of the Government Employees Pension Law, 1996, as amended by section 12 of this Act.

Rule 14.10.9 of the GEPF Rules has further been amended to provide as follows:

14.10.9 In respect of members who divorce on or after 1 August 2019, the Fund shall, in respect of any benefit accruing to such member and in consultation with the actuary for the purposes of calculating the benefit payable to the member, substitute a member's actual pensionable service with the reduced pensionable service to take into account the pension interest of the member which was assigned to any former spouse of the member.

14.10.9.1 in respect of members who divorced prior to 1 August 2019 and whose former spouse was paid a portion of the member's pension interest and which member notified the Fund in the prescribed period that he or she still wishes the divorce debt to be applied to him or her, then the benefit payable to such member must be reduced by the divorce debt.

14.10.9.2 if the amount of the divorce debt exceeds the amount of the gratuity and there is an annuity payable to the member, then the divorce debt must be recovered from the gratuity and annuity and the gratuity and annuity be reduced pro-rata—

(a) the capital values of the gratuity and annuity must be determined by the actuary;

(b) the values determined by the actuary must be reduced pro-rata by an amount equal to the balance of the divorce debt then remaining; and

(c) the capital values that results from this calculation must be annuitised by the actuary on a basis determined by the board in consultation with the actuary to determine the amount of the gratuity and annuity which will then be payable.

In this regard the definition of "divorce debt" has also been amended in Rule 1 of the GEPF:
"divorce debt" *in relation to a member means,* ***in respect of a member who divorced prior to 1 August 2019 and those former spouse was paid a portion of the member's pension interest and which member notified the Fund in the prescribed period that he or she still wishes the divorce debt approach to be supplied to him or her****, an amount equivalent to the amount of the pension interest assigned to the member's former spouse in terms of a divorce order or decree of dissolution of marriage accumulated from the date of payment to the former spouse to the date on which a benefit is paid to the member in terms of the rules together with the interest from the date of payment to the former spouse at the rate or rates determined from time to time by the Board as the rate or rates of interest payable in respect of monies owed to the Fund, adjusted by any amounts repaid to the Fund by the member to reduce this divorce debt.*

From the amended rule it would thus appear that:

1. Where a member of the GEPF was divorced **on or after 1 August 2019** and the former spouse of the member was paid a portion of the member's pension interest, the member's benefit would be reduced in terms of a reduction (calculated by the Fund actuary); and
2. Where a member of the GEPF was divorced **before 1 August 2019** and the former spouse of the member was paid a portion of the member's pension interest, the member has a choice:
   (a) If the member wished the divorce debt to be applicable to the divorce, the member must notify the Fund in the prescribed period that he/she still wished the divorce debt to be applicable to him/her (in my view the prescribed period, if one looks at the provisions of Section 13 of the Financial Matters Amendment Act discussed above, it would appear that such notification has to be given within 12 months of commencement of this section, i.e. within 12 months after 23 May 2019 (date of enactment of the Financial Matters Amendment Act).

(b) If the member does not provide the notification as provided for in par 2(a) above, the member's benefit would be reduced in terms of the reduction (calculated by the Fund actuary) as provided for in paragraph 1 above.

When a pension interest is awarded to a non-member spouse in a divorce order, such non-member spouse has the following options[31]:
(i) Transfer the award to another approved retirement fund; or
(ii) Take the benefit in cash.

The question of whether a non-member spouse may elect to take a portion of the benefit in cash and transfer the balance of the benefit to an approved fund arose, and in response the South African Revenue Services (SARS) has issued a non-binding private opinion[32]. SARS is of the opinion that Section 37D(4)(b)(i) does not make provision for the non-member spouse to take a portion in cash and transfer the balance. They hold the view that the non-member spouse is only entitled to exercise either one of the two options but not to a combination of the two options.

The process to be followed where a pension interest has been awarded to a non-member spouse in divorce proceedings is as follows[33]:
(i) The fund must ask the non-member spouse how the benefit is to be paid, within 45 days or receiving the divorce order;
(ii) The non-member spouse must notify the fund within 120 days whether the amount is to be paid in cash or transferred to another retirement fund;
(iii) The fund must give effect to this election within 60 days;
(iv) Interest is payable on the amount from the expiry of the 120 day election period;
(v) Where the non-member spouse does not make the election within the 120 days, the fund must make the payment in cash within 30 days thereafter.

2.8 Tax

We have to distinguish between divorce orders issued prior to 13 September 2007 and those orders issued after that date.

Divorce Orders prior to 13 September 2007:

[31] Section 37D(4)(b)(i) of the Pension Funds Act 24 of 1956
[32] As contemplated in Section 75 of the Tax Administration Act 28 of 2011, as amended
[33] 37D(4)(a) and (b) of Pension Funds Act

- Where the deduction was made between 1 November 2008 and 1 March 2009, the member spouse was regarded as the tax payer. The divorce order was taxed at the member's average rate of tax.
- Where the deduction is made after 1 March 2009, no tax is payable.[34]

Divorce Orders after 13 September 2007:

- Where the deduction was made prior to 1 March 2009, the member spouse was liable for the tax. The amount awarded to the non-member spouse in terms of the divorce order was taxed at the member's average rate of tax.
- Where the deduction was made on or after 1 March 2009, the non-member spouse is liable for the tax on the amount awarded, if such member elects to take the award in cash. The retirement lump sum withdrawal tax table is applied in these circumstances:

All taxable retirement fund lump sum withdrawal benefits which accrued as from 1 March 2009, retirement lump sum benefits which accrued as from 1 October 2007 and severance benefits accrued as from 1 March 2011 are aggregated. This aggregated amount is calculated according to the table below:	
Taxable income from lump sum benefit	Rate of Tax
R0 – R25 000	0% of taxable income
R25 001 – R660 000	18% of the taxable income exceeding R25 000
R660 001 – R990 000	R114 300 plus 27% of the taxable income exceeding R660 000
R990 001 and above	R203 400 plus 36% of the taxable income exceeding R990 000

The non-member spouse may elect to have the award transferred tax free to another approved retirement fund. The following transfers would be tax free:

From	To
Pension Fund Pension Preservation Fund	Pension Fund Pension Preservation Fund Retirement Annuity Fund
Provident Fund Provident Preservation Fund	Provident Fund Provident Preservation Fund Pension Fund

[34] Taxation Laws Amendment Act 2012

	Pension Preservation Fund Retirement Annuity Fund
Retirement Annuity Fund	Retirement Annuity Fund

2.9 Deferred Pension Benefit

If the rules of a pension or provident fund allow it, a member of such a fund may, on exit from the fund prior to retirement (e.g. on resignation form employment, retrenchment or dismissal), elect to postpone/defer his/her retirement date subject to not being able to make further contributions to the fund.

In the matter of Eskom Pension and Provident Fund v Elizabeth Krugel[35], the Supreme Court of Appeal had to decide whether a deferred pensioner's benefit in a fund could be a deemed asset on divorce.

The court considered the definition of pension interest which in relation to pension and provident funds specifically refers to the benefits that the member would have been entitled to on resignation from office on date of divorce. In the case of a deferred member, he/she has already resigned from office before date of divorce and therefore the court held that since the member had no interest in the fund at date of divorce, he no longer had a pension interest in the fund and as such the ex-spouse was not entitled to have the benefit included in the divorce as a deemed asset.

It is interesting to note that the respondent attempted to rely on section 37D of the Pension Funds Act which extends the definition of pension interest in relation to pension- or provident preservation funds by referring to "the equivalent portion of the benefits to which that member would have been entitled to in terms of the rules of the fund if his or her membership of the fund terminated on the date on which the decree was granted." The court dismissed this reliance as it is applicable to preservation funds only. This creates the following anomaly where a member of a pension or provident fund exits the fund prior to retirement:

(i) If the member opts to preserve his or her retirement interest in the pension or provident fund after resignation/dismissal/retrenchment (assuming that the fund rules make provision for this), and such member is divorced after the date of preservation, the non-member would

[35] 2011 ZASCA 96

not have a claim against the retirement interest in the pension or provident fund, as it would fall foul of the definition of "pension interest" in section 1 of the Divorce Act.

(ii) If the member however opts to transfer his or her retirement interest to a pension preservation fund or provident preservation fund after resignation/dismissal/retrench-ment, and such member is divorced after the date of transfer, the non-member would have a claim against the retirement interest in the pension preservation fund or provident preservation fund, as it would fall within the ambit of the extension of the definition of "pension interest" in section 37D(6) of the Pension Funds Act.

(iii) Similarly, if a member of a pension or provident fund opts to transfer his or her retirement interest to a retirement annuity fund after resignation/dismissal/retrenchment, and such member is divorced after the date of transfer, the non-member would have a claim against the retirement interest in the retirement annuity fund, as it would fall within the ambit of the definition of "pension interest" in section 1 of the Divorce Act.

Prior to 1 March 2015, members of retirement funds did not have the option to preserve their retirement interest upon reaching retirement age in terms of the rules of the fund. This was particularly relevant as far as pension and provident funds were concerned, as the retirement date in terms of the funds rules usually coincide with reaching the age on which the member has to retire from employment. The reason for this is that paragraph 4(d) essentially provided that a lump sum benefit was deemed to have accrued to a member upon reaching retirement age. This essentially meant that a member could not preserve his retirement interest upon reaching normal retirement age.

The Explanatory Memorandum to the 2014 Taxation Laws Amendment Bill set summarises the reason for a required change as follows:

"There are instances where, by the date of retirement, individuals have not made an election as to the amount of the retirement fund interest they wish to receive as a lump sum. In these cases, funds are unable to calculate or withhold the required amount of income tax, thus falling foul of the withholding obligations. Further complications arise since the amount of the lump sum that is provided to SARS in the tax directive is based on the amount in the fund on the date of accrual, which may be different to the date on which the individual made an election.

The current stipulation also provides little flexibility for the individual to determine when they would like to start receiving their pension benefits, as it is determined by the normal retirement age of

the fund. It is thus difficult for individuals to preserve their retirement fund assets at retirement, which may be preferable if they would like to continue in employment beyond their normal retirement age (if the fund rules allow them to do so)."

In terms of the Explanatory memorandum of the 2014 Taxation Laws Amendment Bill, the following solution was proposed to overcome this problem:
"It is proposed that the date on which the lump sum benefit shall be deemed to accrue to the individual should no longer be dependent on the normal retirement age, but instead should be the date on which the election by the individual takes place.

Individuals may then extend their own date of retirement according to their own circumstances and when they would prefer to start receiving their pension benefits, enhancing preservation. However, the ability to extend the date of retirement is not a requirement and is wholly dependent on the rules of the fund."

In terms of Section 71 of the 2014 Taxation Laws Amendment Act[36], paragraph 4(d) of the Second Schedule to the Income Tax Act was deleted from 1 March 2015. This meant that persons that had reached normal retirement age, could essentially preserve their benefits until such time as they elected to retire from the fund.

From 1 March 2018, members of pension or provident funds now also have the option at retirement of transferring their benefit to a retirement annuity if the rules of the transferring fund allow it[37]. The member can then make further contributions to the retirement annuity should they wish to do so.

From 1 March 2019, members of pension funds may also, at retirement, transfer their benefit to a pension preservation fund if the rules of the fund allow it[38]. Similarly, members of provident funds may, at retirement, transfer their benefit to a provident preservation fund. The member will however not be allowed to make a withdrawal from the pension preservation or provident preservation fund prior to retirement. In this regard such transfers differ from transfers made to preservation funds prior to reaching normal retirement age in a pension or provident fund, where one withdrawal from the preservation fund prior to retirements therefrom is allowed.

[36] Act 43 of 2014
[37] This change was brought about by the enactment of the Taxation Laws Amendment Act 17 of 2017.
[38] This change was brought about by the enactment of the Taxation Laws Amendment Act 23 of 2018.

In light of the language used in the Divorce Act and Pension Funds Act to define the term "pension interest" and the Krugel judgment, it is clear that the same dilemma will be faced with regards to the situation where a member of a fund elects to preserve his or her retirement interest after reaching normal retirement age in terms of the rule of a pension or provident fund:

(i) If the member opts to preserve his or her retirement interest in the pension or provident fund upon reaching normal retirement age (assuming that the fund rules make provision for this), and such member is divorced after the date of preservation, the non-member would not have a claim against the retirement interest in the pension or provident fund, as it would fall foul of the definition of "pension interest" in section 1 of the Divorce Act.

(ii) If the member however opts to transfer his or her retirement interest to a pension preservation fund or provident preservation fund upon reaching normal retirement age, and such member is divorced after the date of transfer, the non-member would have a claim against the retirement interest in the pension preservation fund or provident preservation fund, as it would fall within the ambit of the extension of the definition of "pension interest" in section 37D(6) of the Pension Funds Act.

(iii) Similarly, if a member of a pension or provident fund opts to transfer his or her retirement interest to a retirement annuity fund upon reaching normal retirement age, and such member is divorced after the date of transfer, the non-member would have a claim against the retirement interest in the retirement annuity fund, as it would fall within the ambit of the definition of "pension interest" in section 1 of the Divorce Act.

It is thus clear from the above, that there is a discrepancy in the way pension interest is applied to pension and provident funds as opposed to retirement annuity and preservation funds, where a member elects to preserve his or her retirement interest, whether such preservation takes place before, or upon reaching normal retirement age. If a member decides to leave his or her benefit in the pension or provident fund, there is no pension interest to be attached in a divorce, but a member who elects to transfer to a retirement annuity or preservation fund, is open to having funds attached as there is a pension interest forming part of his or her assets for divorce purposes. It is my submission that the definition of pension interest would have to be amended to create uniformity as it could never have been the intention of the legislator to create such an unfair anomaly.

3. Compulsory Annuities

Compulsory annuities are annuities which are purchased with funds from pension, provident, retirement annuity, pension preservation or provident preservation funds on retirement.

Broadly speaking, compulsory annuities fall into two categories, namely member owned (GN 18) and fund owned annuities. A member owned annuity is an annuity which the member purchases on retirement from a long term insurer. Member owned annuities are subject to GN18 and the Long Term Insurance Act and not the Pension Funds Act. GN18 prohibits the transfer or assignment of the annuity as contemplated by the Pension Funds Act[39]. A fund owned annuity is an annuity which is provided directly by a retirement (pension, provident, preservation or retirement annuity) fund, as opposed to a member purchasing an annuity from a long term insurer. Fund owned annuities are subject to the Pension Funds Act and the members would be classified as a pensioner in terms of the definitions thereof.

The next question that needs to be answered is whether compulsory annuities are deemed to be assets of a person for purposes of divorce proceedings.

The definition of pension interest as provided for in section 1 of the Divorce Act, read with Section 37D(5) and (6) of the Pension Funds Act, ad discussed earlier, does not extend to compulsory annuities.

Section 37D(1)(d)(i) of the Pension Funds Act, however indicates that it may be possible to take a compulsory annuity into consideration in divorce matters:

37D. Fund may make certain deductions from pension benefits. —

(1) A registered fund may—

> *(c) deduct from a member's or deferred pensioner's benefit, member's interest or minimum individual reserve, or the* ***capital value of a pensioner's pension after retirement****, as the case may be—*
>
> *(i) any amount assigned from such benefit or individual reserve to a non-member spouse in terms of a decree granted under section 7 (8) (a) of the Divorce Act, 1979*

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[39] "The annuity so purchased, as is the case with an annuity purchased in the name of a retirement fund or paid directly by such a fund, must be compulsory, non-commutable, payable for and based on the lifetime of the retiring member and may not be transferred, assigned, reduced, hypothecated or attached by creditors as contemplated by the provisions of Section 37A and 37B of the Pension Funds Act, 1956"

(Act No. 70 of 1979) or in terms of any order made by a court in respect of the division of assets of a marriage under Islamic law pursuant to its dissolution;

In JN Koekemoer V ABSA Pension Fund and Another[40] the pension Funds Adjudicator was tasked with making a ruling on whether a fund pension (annuity) should be taken into account as being part of the assets of a person in divorce proceedings. The Fund refused to do this on the basis that even though section 37D(1)(d)(i) had been amended as stipulated above, there was still a legal shortcoming in that the definition of "pension interest" in the Divorce Act had not been amended accordingly.

The Tribunal noted that prior to 28 February 2014 the law did not allow a non-member spouse, in a divorce which took place after the payment of a retirement benefit; to claim against the pension benefit. It found that this placed such a non-member spouse at an unfair disadvantage as opposed to a non-member spouse in a divorce which took place before the payment of a retirement benefit and that the amendment to section 37D(1)(d)(i) had been made to address this unfairness. The Tribunal referred to Paulse v Sanlam Staff Umbrella Pension Fund and Others[41] in which the amendment to section 37D(1)(d)(i) in relation to the definition of "pension interest" was tested around the issue of Islamic marriages. There the Tribunal took the view that it could not accede to a request for the parties to wait until an amendment is made to the relevant pieces of legislation, as it would be perpetuating a differentiation which cannot be justified in a democratic and multi-cultural society as ours. The Tribunal went on to state that "*it cannot be party to the perpetuation of injustice and discrimination against parties married and divorced in terms of Islamic tenets, where it is clear that the legislature intended them to be treated in a similar fashion as parties in civil and customary marriages, and where parties have reached an agreement regarding the payment of pension interest and made such an agreement an order of the court*".

However, in this matter, the Tribunal had to dismiss the complaint because the actual wording in the settlement agreement did not align with the stated intention of the Complainant - it referred to "pension interest" and not to "the capital value of the pension". Therefore, the Tribunal was unable to determine which interests must prevail between the Fund's view that payment of the capital value is problematic to implement in as far as it is inconsistent with the definition of "pension interest" and the Tribunal's view in the Paulse matter that the intention of the legislature

[40] PFA/GP/00025359/2016/MD
[41] PFA/WC/00011266/2014/MD

and the continued prejudice suffered by non-member spouses due to an element of differentiation must override the defect in the legislation. It would however appear that the Tribunal may have found in favour of the complainant if the settlement agreement had been worded differently.

In the matter of Montanari v Montanari[42] the court had to consider whether the living annuity should form part of the accrual in the parties divorce proceedings. The court considered the definition of pension interest and confirmed that Mr Montanari's pension interest had ceased when he retired. The court also considered whether the capital had vested in Mr Montanari for purposes of the accrual calculation and concluded that a member does not have a claim to the capital (the only exception being when the capital falls to below the amount gazetted[43]) but only has a claim to the annuity which could not be assigned or transferred. This judgment thus appear to be in contrast with the finding of the Pension Funds Adjudicator in JN Koekemoer V ABSA Pension Fund and Another, discussed above.

It is submitted that the judgement in the Montanari is correct. The finding of the Pension Fund Adjudicator in the Koekemoer matter is problematic in the following regard:

(i) The definition of pension interest needs to be changed in the Divorce Act to make provision for annuities/pension received after retirement to form part of a person's estate for divorce proceedings. Section 37D(1)(d)(i) of the Pension Funds Act refers to Sec 7(8)(a) of the Divorce Act, which section regulates issues surrounding pension interest, as defined.

(ii) The Pension Funds Act in general, and thus also Section 37D, is only applicable to pension, provident, retirement annuity and preservation funds. The implication of this is that it is only regulates annuities provided by these funds (fund owned annuities) and not member owned (GN18) annuities, which are regulated by the Long Term Insurance Act. .

Therefore, even if a distinction is made between member-owned and fund-owned annuities, the result in this regard should be the same, namely that without legislative amendments these annuities should not be considered as assets for purposes of divorce proceedings.

[42] Unreported judgment of the High Court (GN). Case No 14/26868.

[43] Currently R75 000 if the member had not taken a lump sum at retirement or R50 000 if the member had taken a lump sum at retirement.

Conclusion

It is my view that, in order to achieve the equitable outcomes, the following legislative amendments need to be made:

(i) The definition of "pension interest" in the Divorce Act should be amended with regards to pension and provident funds to provide that the pension interest would be equal to "*the benefits to which that member would have been entitled to in terms of the rules of the fund if his or her membership of the fund terminated, or the member or the deferred pensioner retired on the date on which the decree was granted.*" The definition would thus mirror the definition of the pension interest in a preservation fund and ensure that, in the case of deferred members of these funds (whether the retirement interest was preserved at a date prior to reaching normal retirement age or after normal retirement age), non-member spouses are afforded equal rights to spouses of members of preservation funds.

(ii) Consideration should also be given to amend the definition of the pension interest in a retirement annuity fund. It is submitted that there is no just reason for quantifying the value of a pension interest in a retirement annuity fund different from any other type of retirement fund. The quantification of the value of the pension interest in a retirement annuity fund would usually require a calculation by an actuary, and in the absence of such a calculation, it leave the parties to divorce proceedings in a situation where there may be uncertainty on the values that need to be used in negotiating a settlement with regards to the patrimonial consequences of the marriage.

(iii) If it is the intention of the legislature to also include the value of compulsory annuities purchased after retirement in the estate of a person for purposes of divorce proceedings, the definition of "pension interest" in the Divorce Act should be amended to make provision for this.

(iv) Amendments in this regard should preferably be made in the Divorce Act, and not the Pension Funds Act. It is submitted that having prescriptive provisions with regards to the patrimonial effect of retirement benefits in different statutes causes confusion. With regards to member owned (GN18) compulsory annuities it is even more important, as the Pension Funds Act generally does not regulate provisions related to member owned annuities. Section 37A(1) of the Pension Funds Act could however be amended to make reference to the Divorce Act as one of the exceptions to the protection of retirement benefits.

This article highlights the importance of obtaining advice and executing proper planning prior to a divorce order being granted.

It is important for clients to understand if, and to which extent retirement benefits form part of their estates for divorce purposes, as well as the legislative requirements that need to be complied with in order to make a divorce order pertaining to retirement benefits enforceable against a retirement fund. The consequences of having a divorce order which is non-compliant with legislation could result in undue hardship if a client is forced to bring an application to court to have a divorce order amended.

Issues related to divorce orders, including, but not limited to, the options available for the non-member spouse and the tax consequences thereof should also be canvassed with clients.

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Living Annuities:
A summary of the Status Quo

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Introduction

The purpose of this article is to provide a summary of the most frequent questions and answers in the industry on living annuities. The article is aimed at assisting financial advisors on the most pertinent issues surrounding living annuities. The definition of a living annuity is discussed, and thereafter the following topics are analysed: living annuities and beneficiary nominations, living annuities and death, the options available to beneficiaries on death of the annuitant, living annuities and divorce and whether a trust *(inter vivos* or testamentary) can be nominated as beneficiary on a living annuity.

1. Ownership of a living annuity

A living annuity is defined in section 1 of the Income Tax Act[1] as follows:

"living annuity means a right of a member or former member of a pension fund, pension preservation *fund, provident fund, provident preservation fund or retirement annuity fund, or his or her dependants or nominee, or any subsequent nominee, to an annuity purchased from a person or provided by that fund on or after the retirement date of that member or former member…"*

It is clear from the definition that living annuities are bought after the retirement date and can be provided by a long term insurer (referred to as a member owned living annuity) or provided by the retirement fund (referred to as a fund owned living annuity).

Where the annuity is member owned, section 37C of the Pension Funds Act[2] is not applicable. The annuitant may thus nominate a beneficiary of his/her choice and it will not be in the discretion of retirement fund trustees, within the ambit of section 37C, whether to allow the benefit to be payable to the beneficiary or not. This is also one of the reasons why member-owned living annuities are so popular amongst clients, since they want be in control of their beneficiary nominations.

[1] Act 58 of 1962
[2] Act 24 of 1956

2. Drawdown rates:[3]

The drawdown rates applicable to living annuity contracts differs where the living annuity contract was concluded before 21 February 2007, as opposed to where it was concluded on or after 21 February 2007.

Where the living annuity contract was concluded before 21 February 2007, the annual drawdown rate is limited to an amount equaling a minimum of 5% and a maximum of 20% of the value of the assets[4]. These percentages may be adjusted to the percentages applicable to living annuity contracts entered into after 21 February, if the annuitant agrees to be bound by these income levels and by the adjustments of the rates.

Where the living annuity contract was concluded on or after 21 February 2007, the minimum allowable annual drawdown rate is 2.5% and the maximum annual drawdown rate is 17.5% of the value of the assets[5].

The annuitant elects a draw-down percentage within the limits at inception of the contract. The annuitant may only elect a different draw-down percentage annually on the anniversary date, provided that the adjusted draw-down is within the limits set. A different draw-down percentage may not be elected at any other time.

If an annuity is transferred from one insurer to another, or from a retirement fund to an insurer, the frequency of the payment may not be changed and the annuity may not be split so that more than one annuity is payable after the transfer. If the administrative systems of an insurer to which an annuity contract is transferred is not capable of accepting the original date of the annuity as the anniversary date, the anniversary date may be changed to the date of the transfer. In this regard the following is important:

(i) Where the anniversary date remains the same as under the contract that it is transferred from, the drawdown rate can be reviewed on the anniversary date as normal; but

(ii) Where the anniversary date is changed on the date of transfer, the drawdown rate may only be reviewed 12 months after the date of transfer.

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[3] GN 290, Government Gazette 32005 dated 11 March 2009.
[4] Ibid
[5] Ibid

Any living annuity contract concluded after 21 July 2007 must contain a clause that will enforce any future adjustments to the drawdown rates.

3. Valuation

The valuation of a living annuity is prescribed paragraph (a) of the definition of "living annuity in section 1 of the Income Tax Act[67] as follows:

"the value of the annuity is determined solely by reference to the value of the assets which are specified in the annuity agreement and are held for purposes of providing the annuity".

4. Guarantees and underlying assets

In terms of paragraph (d) of the definition of "living annuity in section 1 of the Income Tax Act "the amount of the annuity is not guaranteed by that person or fund".

Member-owned living annuities are not governed by Regulation 28[8], as it is not regulated by the Pension Funds Act, whilst fund owned living annuities are subject to Regulation 28. The ASISA Standard on Living Annuities[9] however encourages investments in underlying assets similar to the provisions in Regulation 28, although it is not compulsory. According to the ASISA Standard on Living annuities[10], the nature of a living annuity is such that clients bear the investment and longevity risk in full. ASISA goes further to say that the income over the annuitant's lifetime will ultimately depend on the lifespan length of the annuitant, the selected drawdown rates and the investment performance of the chosen funds. Whilst guidance can increase the probability of a sustainable income for life, the nature of the living annuity product means that this can never be guaranteed.

5. Living annuity beneficiary nominations and death of the annuitant:

Paragraph (e) of the definition of "living annuity" provides that:

"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."*

[6] Income Tax Act 58 of 1962
7Income Tax Act 58 of 1962
[8] Of the Pension Funds Act 24 of 1956
[9] ASISA Standard on Living annuities, www.asisa.org.za
[10] Ibid

It is clear thus from the above that:

(i) where there is a beneficiary nominated, the proceeds will be paid to the nominated beneficiary, and that such beneficiary will have a choice to receive the benefit either as a lump sum, or an annuity, or a combination of a lump sum and annuity; and

(ii) where there is no beneficiary nominated, the proceeds will be paid to the estate of the deceased annuitant as a lump sum. The option of receiving the benefit as an annuity will thus not be given in absence of a beneficiary nomination.

Where there is no beneficiary nominated (thus no nominee), the lump sum will be payable to the annuitant's estate and tax on the lump sum will be payable, as well as executors fees and VAT thereon if the executor is registered for VAT purposes. It is thus of utmost importance to rather nominate a beneficiary on the living annuity of a client, as omitting to do so will in all probability result in a reduction in the value of the living annuity due to tax and executors fees becoming payable on the lump sum.

The question that arises is what exactly qualifies as a nominee: Is it only when a beneficiary is nominated on a beneficiary nomination form of the insurer, or would a nomination in an annuitant's will also be seen as a valid nomination of a nominee?

It appears that the SARS follows a "restrictive interpretation"[11] of the term nominee, and in their view a nominee only constitutes a nominee when someone is nominated on a beneficiary nomination form of the insurer, and not via nomination in a will. Therefore, if a client nominates a beneficiary in a will, the living annuity will be commuted as a lump sum resulting in tax being paid thereon, and the balance will be paid to the estate of the annuitant.

In a non-binding opinion, SARS expressed the view[12] that where the estate is nominated on a beneficiary nomination form as the beneficiary, the executor of the deceased estate is the representative nominee and will thus have the choice between an annuity, a lump sum or a combination of an annuity and a lump sum. It is however important to note that the nomination of an estate will only be possible if the living annuity product allows for such a nomination. This should also be distinguished from a living annuity where no beneficiary nomination is made, as discussed in the previous paragraph.

[11] Legal Aspects Presentation by Carl Muller presented at the Old Mutual Personal Finance Legal Advisor Conference in 2018.

[12] Ibid

Member-owned living annuities are not subject to section 37C of the Pension Funds Act, which means that the nominated beneficiaries will receive the benefit on the death of the annuitant, and that there is no trustee discretion involved. The beneficiary must survive the annuitant to accept the benefit. Where more than one primary beneficiary have been nominated, and one of them pass away and the annuitant did not replace the beneficiary with another beneficiary, the share of the beneficiary that passed away will be shared by the surviving primary beneficiaries[13].

Some insurance companies allow the nomination of alternative beneficiaries[14] to the initial primary beneficiaries being nominated. Alternative beneficiaries will usually only benefit if all the initial primary beneficiaries have passed away, and if the annuitant did not nominate new primary beneficiaries. This tendency of nominating alternative beneficiaries is becoming more and more popular.

As mentioned above, a nominated beneficiary has three options available on the death[15] of the annuitant namely:

(i) Continue with the annuity in his/her own name, or
(ii) Commute the full amount as a lump sum and pay tax according to the retirement tax tables on it; or
(iii) A combination of (i) and (ii) above, i.e. take a portion in cash and transfer the balance to a living annuity in his/her own name, and receive an income.

6. Can a trust (*inter vivos* or testamentary) be nominated as a beneficiary on a living annuity?

Paragraph (e) of the definition of a living annuity in section 1 of the Income Tax Act makes provision for payment of the benefits of a living annuity to a nominee on the death of a member or former member of a retirement fund. The Act does however not define what a nominee is, not does it indicate that a nominee must only be a natural person. This definition thus does not prohibit the nomination of a trust (testamentary or inter vivos) as a nominee (beneficiary) on a living annuity.

[13] Investec Legal Update, Investec Living Annuity – Options for beneficiaries, March 2018
[14] Ibid
[15] Paragraph (e) of the definition of "living annuity" in section 1 of the Income Tax Act 58 of 1962

It was previously a contentious issue whether an *inter vivos* trust will be allowed as a beneficiary on a living annuity, because SARS was of the opinion that a living annuity is for the benefit of a natural person as a beneficiary and that when that beneficiary dies, the living annuity comes to an end[16].

SARS has however since confirmed that it is allowable for trusts (*inter vivos* and testamentary trusts) to be nominated as beneficiaries on a living annuity contract[17]. It however appears that it is a requirement that the beneficiaries of the testamentary trust or the *inter vivos* trust are natural persons[18] in these circumstances. On death of the annuitant who nominated the trust as beneficiary, the trustees of the trust will have the same choice as individual beneficiaries[19].

Financial advisors should however enquire whether the rules of the product chosen allows for the nomination of a trust as a beneficiary on a living annuity, and if it does whether the product rules permit the three options discussed above on the death of the annuitant. Some products provide the option to appoint a trust as beneficiary on a living annuity, but the product rules may dictate that the full value of the living annuity has to be commuted as a lump sum upon the death of the annuitant. It is important that advisers take note of this, since the duty to provide sound advice does not cease with the granting of the wish of the client to nominate the trust as beneficiary on the living annuity – the client has to be made aware of the options available on death and the subsequent tax consequences of the decision as well. If the client is aware of the impact of the tax on the lump sum, chances are that the client may want to reconsider his/her options and make an informed decision, depending on the specific circumstances.

Also bear in mind that where a testamentary trust is nominated as beneficiary, the income paid by the living annuity will cease until the trust is registered and a bank account is opened[20].

If an insurer allows the trustees to opt that the trust receives an annuity income, the next question that needs to be answered is how this income will be taxed. The general rule with trust income is that trust income of a trust is taxed in the hands of the trust, unless such income vests in one or more of the trust beneficiaries in the same year that the income accrued to the trust, in which

[16] Glacier by Sanlam, Simply Legal, Issue 2, 26 January 2017: Nominating a trust as a beneficiary on an ILLA.
[17] Letter of Institute of Retirement Funds Africa to Retirement Fund Section, South African Revenue Service, dated 17 February 2017
[18] Investec Legal Update, Investec Living Annuity – Options for beneficiaries, March 2018
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case it is taxed in the hands of the hands of the beneficiaries[21]. Initially SARS did not apply this principle to living annuities paid to trusts, and the income was taxed at the rate applicable to trusts (currently 45%) regardless of whether the trust is a vesting or a non-vesting trust[22]. SARS have since changed their stance on this issue and the income of a living annuity paid to a trust. In a letter to the Institute of Retirement Funds Africa dated 27 September 2015, SARS states the following[23]:

"Your application regarding the possibility of applying for a tax directive to allow the administrator to withhold tax at a different tax rate than that of a trust was considered.

SARS is prepared to consider the possibility of issuing a tax directive to an administrator, allowing the administrator to refrain from withholding any amount of employees' tax from the annuity income that ultimately accrues to the vested beneficiaries, provided the administrator is satisfied that the following conditions have been met by the trust:

- *The trust is registered as an employer; and*
- *The trust provides a tax clearance certificate to the administrator, on an annual basis, as proof that the trust submitted the required returns and all taxes have been paid."*

From a practical perspective this would mean:

(i) the trust registers for PAYE (pay as you earn); and

(ii) if the trust thereafter requests a tax directive from SARS in writing indicating at which rate the trust must withhold income tax.

SARS would issue the administrator of a living annuity with a directive which would allow such administrator to pay the gross living annuity income to the trust without having to withhold PAYE[24].

The result of this would thus be that the trust would not be taxed (due to SARS issuing the administrator of the living annuity with a nil directive), but the trustees of the trust will have to withhold tax at the marginal rate of the relevant beneficiaries (as per the tax directive received from SARS). Therefore, the beneficiary is effectively taxed at his/her marginal rate, whilst the trust is not taxed (whereas it would otherwise have been taxed at 45%). It is however advisable to ensure that the operating systems of a living annuity administrator is equipped to deal with the tax process as set out above.

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[21] Section 25B of the Income Tax Act. Section 25B is however subject to the exceptions provided for in Section 7 of the Income Tax Act, but these exceptions are not relevant for this article

[22] Glacier by Sanlam, Simply Legal, Issue 2, 26 January 2017: Nominating a trust as a beneficiary on an ILLA.

[23] Letter of Institute of Retirement Funds Africa to Retirement Fund Section, South African Revenue Service, dated 17 February 2017

[24] I*bid*

The next aspect that needs to be canvassed is where a trust is nominated as the beneficiary on a living annuity contract, and the trusts opts to receive the benefit in the form of an annuity, whether it will be allowed to commute the living annuity benefit in the future. A practical example would be where a testamentary trust is the recipient of a living annuity, and the beneficiary of the trust dies, with the result that the trust has to be terminated as per the will of the deceased. Another example would be where the trust is wound up on a decision taken by the trustees, where the trust deed provides for this.

The one view is that where a trust is terminated[25], the nominated beneficiaries of the trust will have the three options (as mentioned in paragraph 5 of this article) in respect of the living annuity that is available to beneficiaries in terms of the Income Tax Act, where an annuitant dies. If the trustees did not nominate beneficiaries, or if the beneficiaries are predeceased, the benefit will be paid out as a lump sum to the trust, in which case tax at a rate of 45 % (applicable to trusts) will be deducted from the lump sum. If a beneficiary was nominated by the trustees, and the beneficiary choose to receive a lump sum, the lump sum will be taxed according to his/her marginal tax rate. In terms of this interpretation, because the lump sum is paid out by reason of the termination of a trust, and not due to the annuitant's death[26], tax payable in terms of the retirement tax table will not be applicable. It is uncertain whether SARS currently allows commutation on this basis.

It is my view that the legislation, in its current from does not allow for this. The legislation pertaining to living annuities, essentially makes provision for the commutation of a living annuity in the following instances:

(i) Where annuitant dies[27] (in this regard also see "The commutation of a living annuity discussed below); or

(ii) Where the value of the underlying assets of the living annuity at any time becomes less than[28]:

  (a) R75 000 where the member did not take a lump sum on retirement and used the full retirement interest to purchase the living annuity;

  (b) R50 000 where the member took any amount as a lump sum on retirement and used the balance of the retirement interest to purchase the living annuity.

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[25] Investec Legal Update, Investec Living Annuity – Options for beneficiaries, March 2018

[26] Ibid

[27] Paragraph (e) of the definition of living annuity in section 1, read with paragraph 3A of the Second Schedule of the Income Tax Act

[28] Paragraph (c) of the definition of living annuity in section 1 of the Income Tax Act, read with the relevant notice published in Government Gazette 31544 of 30 October 2008.

It does not appear that the legislation allows for the commutation of a living annuity in the case of a trust being terminated where such trust is the holder of a living annuity, unless the value of the underlying assets of the living annuity is less than the minimum amounts discussed in paragraph 7 below. In this case the *de facto* annuitant would be the trust (being the contracting party in respect of the annuity agreement), and commutation of the living annuity on death would thus not be relevant.

The definition of a living annuity likewise only provides for a nominee on a living annuity to opt for an annuity on the death of the annuitant[29], and in this case the annuitant is a trust and death would thus likewise not be applicable. It would also not be possible for the trust to cede the living annuity to one or more beneficiaries of the trust, as this is prohibited by legislation[30]. It is further doubtful whether it was the intention of the legislature to tax lump sums on commutation in any other manner than what is specifically provided for in respect of retirement fund lump sums as provided for in the relevant legislation[31].

This may be problematic where the trust is to be terminated (especially where the date of termination is determined in the trust deed or the will of a deceased), and in such an instance it may be necessary to take steps to extend or cancel the termination date of the trust. It is of the utmost importance that this aspect is discussed with clients who opt to nominate a trust as the beneficiary on a living annuity where the product allows for the option of an annuity to be paid to the trust.

7. The commutation of a living annuity

A living annuity may be commuted in the following instances:

(i) Where the value of the investment is R75 000 or below and no portion of the retirement interest in the retirement fund from which the living annuity emanates was taken as a lump sum; or where the value of the investment is R50 000 or below and any portion of retirement interest in the retirement fund from which the living annuity emanates was taken as a lump sum[32]. It is

[29] Paragraph (e) of the definition of living annuity in section 1 of the Income Tax Act

[30] Section 37A(1) of the Pension Funds Act 24 of 1956 and SARS General Note 18, Issue 2, dated 1 September 2008.

[31] Second Schedule to the Income Tax Act 58 of 1963, read with Paragraph 9 of Schedule 1 to the Rates and Monetary Amounts and Amendment of Revenue Laws Act, 2018

[32] Paragraph (c) of the definition of "living annuity" in section 1 of the Income Tax Act, read with the relevant notice published in Government Gazette 31544 of 30 October 2008.

submitted that this option to commutate is available to the member, a dependant or nominee or a subsequent nominee as no indication to the contrary is given in the relevant legislation

(ii) On the death of the member, or former member of a pension fund, pension preservation fund, provident preservation fund or retirement annuity fund, the nominee (beneficiary) of such member or former member, may elect to have the remaining value of the annuity paid as a lump sum. Here it is interesting to note that the legislation[33] seems to suggest that a commutation is only applicable on the death of the member (i.e. in the case of a fund-owned living annuity) or former member (i.e. in the case of a member-owned living annuity) of such a fund, and not on the death of a nominee or subsequent nominee.

Paragraph (e) of the definition of *"Living annuity" in section 1* of the Income Tax Act provides *as follows:*

"living annuity" *means a right of a member or former member of a pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund, or his or her dependant or nominee, or any subsequent nominee, 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—*

(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;*

Paragraph 3A of the Second Schedule to the Income Tax Act, however provides as follows:

3A. ***Any lump sum benefit which becomes recoverable from****—*

(a) a pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund; or

(b) an insurer as defined in section 29A (1) if that lump sum benefit is payable by or provided in consequence of membership or past membership of a fund contemplated in ***subparagraph (a)****,*

in consequence of or following upon the death of any person other than a person who is or was a member of that fund *shall, on the date of payment of that lump sum benefit, be deemed to have accrued to the deceased person immediately prior to the death of that person: Provided that—*

[33] Paragraph (e) of the definition of "living annuity" in section 1 of the Income Tax Act 58 of 1962

(i) so much *of any tax payable as is due to the provisions of this paragraph may be recovered from the person by whom the lump sum benefit in question is received;*

(ii) where any *annuity or portion of an annuity (including a living annuity)* ***which becomes payable on or in consequence of or following upon the death of a person other than a person who was a member of any such fund has been commuted for a lump sum****, such lump sum shall for the purposes of this paragraph be deemed to be a lump sum benefit which has become recoverable in consequence of or following upon the death of such deceased person;*

(iii) ***where any such lump sum benefit becomes payable but the dependants or nominees of that person elect an annuity*** *(including a living annuity) that is purchased or provided by that fund, no lump sum benefit shall be deemed to have so accrued to the extent that the lump sum benefit was utilised to purchase or provide the annuity; and*

(iv) where any such lump sum benefit is paid to a pension preservation fund or provident preservation fund as an unclaimed benefit as defined in the Pension Funds Act, no lump sum benefit shall be deemed to have so accrued.

Paragraph 3A of the Second Schedule to the Income Tax Act thus appears to imply that, where relevant, the dependants or beneficiaries of compulsory annuities will be allowed to choose the option of selecting a lump sum on the death of the original annuitant. The language used does not seem to suggest that in the case of a living annuity such a commutation on death of a subsequent annuitant will only be allowable if the value of the underlying assets are less than the amounts discussed in paragraph (i) above. This would make sense from a practical perspective, as a different interpretation of paragraph (e) of the definition of a living annuity would also mean that it is only on the death of the member or former member of the retirement fund that beneficiaries would be permitted to opt for an annuity income or a combination of an annuity income and lump sum, and that these options will thus likewise not be applicable on the death of consequent annuitants. It is submitted that this could not have been the intention of the legislature. As far as my knowledge goes, commutations are allowed in practice by SARS on the death of a dependant, nominee or subsequent nominee if the beneficiary of such a person elects to do so. It is however submitted that paragraph (e) of the definition of "living annuity" should be amended to make it clear that a lump sum commutation is allowable on the death of subsequent annuitants (other than the member of former member) and thus remove any uncertainty that may exist in this regard.

Contrary to the position pertaining to retirement annuity funds[34] and preservation funds[35], a living annuity cannot currently be commuted on the basis of formal emigration or the expiry of a visa. A living annuity can also not be commuted if the annuitant is permanently disabled or terminally ill. [36]

8. Living annuities and divorce

In the event of a divorce where one of the parties has already retired, and is receiving an income from an annuity, the first question that arises is if the annuity income[37] (fixed annuity or living annuity) can be taken into account as an asset for divorce purposes.

To answer this question, one first has to differentiate between an amount that is held by a registered retirement fund, for example a pension, provident fund, pension preservation fund, provident preservation fund and a retirement annuity fund PRIOR to the retirement of the member from such a fund, and an annuity (including a living annuity) received AFTER the retirement of the member from these funds[38]. The member receives a compulsory annuity (including a living annuity) from the fund, such compulsory annuity is only payable to the retired member during their lifetime, and it cannot be paid to a third party during the retired member's lifetime.

The second aspect that must be examined is whether the capital value of the living annuity may be taken into account in executing the patrimonial consequences of the marriage on divorce. To establish the answer to this we first need to look at the relevant legislation that regulates divorce proceedings and retirement benefits.

Section 7(7)(a) of the Divorce Act[39] provides as follows:

(7)(a) In the determination of the patrimonial benefits to which the parties to any divorce action may be entitled, the pension interest of a party shall, subject to paragraphs (b) and (c), be deemed to be part of his assets.

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[34] Paragraph (b)(x)(dd) of the definition of "retirement annuity fund" in section 1 of the Income Tax Act
[35] Paragraph (c)(ii) of the definition of "pension preservation fund" and paragraph (c)(ii) of the definition of "provident preservation fund" in section 1 of the Income Tax Act
[36] Glacier by Sanlam, Did you know, Commutation of a Living Annuity, 14 April 2014
[37] Cover, June 2010, The implications of divorce on a compulsory purchase annuity by Michelle Human, Liberty Group
[38] Ibid
[39] Divorce Act 70 of 1979

The definition of a "pension interest as per Section 1 of the Divorce Act provides as follows:

***"pension interest"**, in relation to a party to a divorce action who—*

(a) is a member of a pension fund (excluding a retirement annuity fund), means the benefits to which that party as such a member would have been entitled in terms of the rules of that fund if his membership of the fund would have been terminated on the date of the divorce on account of his resignation from his office;

(b) is a member of a retirement annuity fund which was bona fide established for the purpose of providing life annuities for the members of the fund, and which is a pension fund, means the total amount of that party's contributions to the fund up to the date of the divorce, together with a total amount of annual simple interest on those contributions up to that date, calculated at the same rate as the rate prescribed as at that date by the Minister of Justice in terms of section 1 (2) of the Prescribed Rate of Interest Act, 1975 (Act No. 55 of 1975), for the purposes of that Act;

Section 37D(5) and (6) of the Pension Funds Act then expands this definition to the following effect:

(5) Despite paragraph (b) of the definition of "pension interest" in section 1 (1) of the Divorce Act, 1979, the total amount of annual simple interest payable in terms of the definition may not exceed the fund return on the pension interest assigned to the non-member spouse in terms of a decree granted in terms of section 7 (8) (a) of the Divorce Act, 1979.

(6) Despite paragraph (b) of the definition of "pension interest" in section 1 (1) of the Divorce Act, 1979 (Act No. 70 of 1979), the portion of the pension interest of a member or a deferred pensioner of a pension preservation fund or provident preservation fund, that is assigned to a non-member spouse, refers to the equivalent portion of the benefits to which that member would have been entitled to in terms of the rules of the fund if his or her membership of the fund terminated, or the member or the deferred pensioner retired on the date on which the decree was granted.

The definition of the word "pension interest" thus only caters for members' interests in pension, provident, preservation or retirement annuity funds PRIOR to retirement, and not for annuities purchased after retirement from these funds. Therefore, in terms of the above provisions a compulsory annuity purchased on retirement does not constitute a pension interest.

Paragraph (c) definition of a "living annuity" in section 1 of the Income Tax Act is also relevant in this regard:

"living annuity" *means a right of a member or former member of a pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund, or his or her dependant or nominee, or any subsequent nominee, 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—*

(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;

In other words, the only instance where a living annuity may be commuted as a lump sum during the lifetime of the annuitant, is if the value decreases below a certain amount (currently R75 000 if the holder of the annuity did not take a lump sum when he/she retired from the fund, and R50 000 when the member did take a lump sum on retirement). This is applicable when the member gives instructions to have the amount commuted when the investment value falls below the said values, and divorce is thus not applicable here.

Section 37A(1) of the Pension Funds Act and SARS General Note 18[40] further prohibit the reduction, transfer cession etc. of a compulsory annuity, unless legislatively provided for.

In the case *JN Koekemoer v Absa Pension Fund and another*[41], the Pension Funds Adjudicator however ruled that a non-member spouse could potentially claim against the capital value of a pensioner's interest in an annuity payable **after retirement**[42] in terms of Sec 37D1(d)(i) of the Pension Funds Act that provides as follows:

37D. Fund may make certain deductions from pension benefits.—(1) A registered fund may—

*(d) deduct from a member's or deferred pensioner's benefit, member's interest or minimum individual reserve, **or the capital value of a pensioner's pension after retirement**, as the case may be—*

(i) any amount assigned from such benefit or individual reserve to a non-member spouse in terms of a decree granted under section 7(8)(a) of the Divorce Act[43],) or in

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[40] Issue 2, dated 1 September 2008

[41] PFA/GP/00025359/2016/MD

[42] Case Law Monitor no 5 of 2016, The capital value of a pension in payment may be subject to a divorce order award by Ashley Lakey, 3 November 2016.

[43] Divorce Act 70 of 1979

terms of any order made by a court in respect of the division of assets of a marriage under Islamic law pursuant to its dissolution;

The problem with the finding is twofold:

(i) the definition of pension interest in the Divorce Act[44] does not currently make provision for annuities/pension received ***after retirement*** to form part of a person's estate for divorce proceedings. Section 37D of the Pension Funds Act refers to Sec 7(8)(a)of the Divorce Act which deals with a pension interest, as defined.

(ii) Sec 37D is only applicable to pension, provident, retirement annuity and preservation funds. In this regard its provisions can therefore only pertain to fund owned annuities and not to member owned (GN 18) annuities.

In the judgment of Montanari, Emilio Pietro Valfredo v Montanari, Charmaine Helen, an unreported judgement of the High Court[45], the Court had to decide whether the capital of a living annuity formed part of the estate of a party for divorce purposes. One of the aspects the Court deemed to be a relevant was the content of General Note 18[46] (GN18) (issued by SARS) which provides that the annuity purchased is compulsory, non-commutable, cannot be assigned, reduced, hypothecated or attached by creditors as contemplated by sections 37A an 37B of the Pension Funds Act (the annuities in question in this case fall within the scope of annuities as envisaged in GN18). The Court held that given the relevant context of a living annuity, the capital thereof does not form part of a party's estate for purposes of an accrual claim on divorce. The writer is in agreement with the Montanari decision, in that the living annuity is not a pension interest and that it does not form part of the estate of the annuitant[47]. It is therefore submitted that a court order assigning part of a living annuity to a non-member spouse is currently not enforceable[48]. If it is the intention of the legislature to include living annuities in the estate of a person for purposes of the patrimonial consequences of a divorce, it is my view that the definition of "pension interest" should be amended to this effect, preferably within the ambit of the Divorce Act, to ensure that it encompasses both fund-owned and member-owned compulsory annuities.

[44] Divorce Act 70 of 1979
[45] Unreported judgment of the High Court (GN) Case No 14/26868
[46] Issue 2, dated 1 September 2008.
[47] Old Mutual Case Law Monitor no 4 of 2016, A Living annuity acquired by a person on retirement from a Pension Fund during marriage does not form part of the accrual in the estate on divorce by Waldo Coetzee, 20 September 2016.
[48] Email dated 29 January 2018 by Carl Muller on subject: Living annuities on Divorce

In the recent Appeal Court case ST versus CT[49] the court determined that a Sanlam Glacier living annuity did not form part of the appellant's divisible assets upon divorce and that the capital of the living annuity belongs to Sanlam and not to the annuitant. The court further determined that the annuitant only has a right to the income of the living annuity during his lifetime and that he does not have a right to the capital during his lifetime. The Court found the following in paragraph 107 and 108 of the judgment:

" [107] The Glacier contract does not result in the appellant being a member of a 'pension fund organisation' as defined in the Pension Funds Act 24 of 1956. His status as such terminated when his interests in his previous retirement annuity funds were applied to purchase the living annuity. The provisions in the Divorce Act dealing with a spouse's 'pension interest' are thus not applicable. It appears to be generally accepted in the pension fund industry that the provisions of sections 37A to 37D of the Pension Funds Act apply to a living annuity purchased in the name of a former member of a retirement annuity fund"

" [108] Having regard to the nature of the Glacier contract, we are of the view that its supposed capital value cannot be included as part of the appellant's accrual. The capital belongs to Sanlam, not the appellant. The appellant's only contractual right is to be paid an annuity in an amount selected by him within the permissible range specified by law. His right to receive any particular annuity instalment is subject to a condition of survivorship, i.e. that he should be alive on the date on which the next annuity instalment becomes payable. If he does not survive to the next date, the fate of the capital will be determined by whether or not he has nominated a beneficiary. The capital may or may not be paid to his estate, depending on whether or not there is such a nomination. "

The court further remarked that the income from the living annuity to the annuitant can be considered for maintenance purposes[50]. The annuitant will however be liable to make the maintenance payments to the ex-spouse, the responsibility does not lay with the insurer [51]. In this regard paragraph 112 of the judgment provides: *" [112] The monthly income derived by the appellant from the annuity, however, forms part of his total income which has a bearing on his means to pay maintenance, if any, to the respondent."*

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[49] *ST v CT* (1224/16) [2018] ZASCA 73 (30 May 2018)
[50] *ST v CT* (1224/16) [2018] ZASCA 73 (30 May 2018)
[51] ASAP Momentum Legal and Technical Update, The Living Annuity (Retirement Income Option), Reviewed August 2019.

9. Living annuities and the default annuity strategy[52]

The implementation on 1 March 2019 of the default regulations to the Pension Funds Act[53] has a threefold impact on an investor's retirement journey namely: default investment portfolios, default preservation and portability and an annuity strategy on retirement.

The third pillar of the default regulations is the fact that the board of trustees of the fund must determine a suitable default annuity strategy for members who are unsure about making investment decisions with their accumulated retirement savings at retirement. The members will not automatically default into the fund's annuity strategy, they will have to instruct the fund accordingly. Retirement funds are required to make retirement benefit counselling available to members, to help them understand what benefits they will receive from their retirement savings. According to Tamryn Lamb[54], head of Retail Distribution at Allan Gray, the implementation of the default regulations does not make independent financial advice less important, in fact it stays very important to help clients tailor their post retirement provision to their own personal circumstances.

In respect of living annuities the Guidance Notice[55] provide additional guidance that living annuities may be paid directly from the fund or from an external provider, provided that the investment choice is limited to a maximum of four (4) investment portfolios, which must be compliant with regulation 28 and 37, and the drawdown levels must be compliant with the prescribed standard.

Where living annuities are paid from the fund through fund owned policies, the Guidance Notice[56] suggests that the funds must monitor sustainability of the income drawn in the living annuities and communicate to members if their drawdown rates are deemed to not be sustainable.

Conclusion

The aim of this article is to provide a summary of the status quo of living annuities in the financial services industry. As a legal adviser, the writer is regularly faced with questions by financial

[52] Mail & Guardian, Default regulations will simplify investment options by Alf James, 1 March 2019
[53] Pension Funds Act 24 of 1956
[54] Mail & Guardian, Default regulations will simplify investment options by Alf James, 1 March 2019
[55] GN 41064, Government Gazette of 25 August 2017, The Default Regulations
[56] Ibid

advisers on the topics discussed in this article. The writer trusts that the issues addressed have been sufficiently unpacked and that this article will assist financial advisers where they are faced with questions pertaining to living annuities.

It is clear that it will be long before the dust will settle on living annuities, and advisers will always have to advise on the impact on living annuities in the event of death and divorce. The implementation of the default regulations also highlights the importance of independent financial advice for clients that came to the crossroad of their retirement journey, where they reap the fruit of their decisions during a lifetime of saving for retirement.

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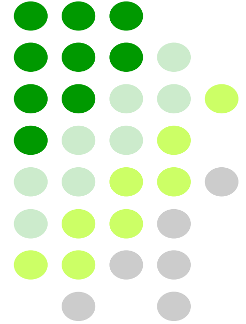

General

‘Uthando Nesthembu’… The Proprietary Consequences of Polygamous Customary Marriages

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Introduction

" Television viewers across the country have recently been captivated by the reality show 'Uthando Nesthembu'. The show follows the fascinating life of a businessman from KwaZulu Natal and his four wives as they showcase their intriguing traditional family life in a twenty first century setting. For all its entertainment value, this hit show has succeeded in breaking down long standing stereotypes and misconceptions regarding the subtleties of polygamous customary marriages. The seemingly harmonious and mutual relationships between the wives, coupled with their seemingly glamourous lifestyle has undoubtedly made polygamy look fashionable again! As a result, polygamy does not seem like such a bad idea after all. However, before you decide to take the plunge into the realm of polygamy, it may be a good idea to first investigate the implications of polygamous customary marriages. "

This article focuses on the estate planning aspects of customary marriages. More specifically, the article explores the proprietary consequences of polygamous customary marriages. The article will highlight potential problems which spouses in such marriages could face as well explore possible solutions to mitigate those problems.

The Law

Customary marriages (monogamous and polygamous) are recognised in terms of The Recognition of Customary Marriages Act (the Act). [1] The Act came into operation on 15 November 2000. The Act is also supplemented by the various traditional customary laws and canons which are still applicable in the country. As with all laws in the country, the Constitution of South Africa[2] forms the bedrock against which these traditional laws and canons are vetted before they can be applied.

What constitutes a valid customary marriage?

By definition, a customary marriage is a union that is negotiated, celebrated and concluded in terms of indigenous African customary law.

For a customary marriage to be recognised as a valid marriage, it has to have been entered into before 15 November 2000.

[1] Act 120 of 1998
[2] Act 108 of 1996

However, if entered into after 15 November 2000, it must comply with the following requirements:

- The marriage must be negotiated, entered into or celebrated in accordance with customary law.
- The prospective spouses must be above the age of 18 years.
- Both prospective spouses must consent to the marriage.

Customary marriages must be registered within three months of taking place. This can be done at any office of the Department of Home Affairs or through a designated traditional leader in areas where there are no Home Affairs offices.

Polygamous marriages entered into after 15 November 2000

According to Section 7(2) of the Act, monogamous customary marriage entered into after the commencement of the Act [3]is a marriage in community of property and of profit and loss[4][5]. This default rule applies unless such consequences are excluded by the spouses in an antenuptial contract before they get married.

Polygamous customary marriages however are by default out of community of property. This means that each spouse retains their own assets and liabilities. According to Section 7(6) of the Act, the proprietary consequences of marriages entered into after the commencement of the Act are regulated by a written contract between the husband and his wives. This contract must be approved by the High Court.Section 7 (6) provides that a husband of an existing customary marriage who is married either in community of property or out of community of property (with accrual) and wishes to enter into a further customary marriage with another woman must apply to the High Court to approve a written contract that will govern the future proprietary consequences of his marriages. The purpose of this provision is to protect matrimonial property rights of the spouses by ensuring a fair distribution of the matrimonial property in circumstances where a husband intends to enter into a further customary marriage.

When considering the application, the court is required to, if the marriage is in community of property or subject to the accrual system, inter alia, terminate the existing matrimonial property

[3] A monogamous is a customary marriage in which a spouse is not a partner in any other existing customary marriage.

[4] This means that all the assets and debt accrued and incurred before the marriage are shared in a joint estate between the spouses; and all assets, debts and liabilities acquired by either spouse after their marriage will be added to the joint estate.

system which is applicable to the current marriage and order a distribution of the matrimonial property.

Example

Mr. Mseleku entered into a customary marriage with MaCele July 2002 (in community of property). In December 2009 Mr. Mseleku proposed to MaMyeni. At that time the joint estate between Mr. Mseleku and MaCele was worth R4 million. Before he can get married to MaMyeni, Mr. Mseleku is required to:

1. Enter into an agreement with both MaCele and MaMyeni setting out their proprietary rights to the matrimonial property.
2. Mr. Mseleko must then make an application to the High court to approve the written agreement.
3. Before the court approves the contract, it is required to terminate the joint estate between Mseleku and MaCele and effect a redistribution of assets.

Both MaCele and Mr. Mseleku will be treated equally and will receive R2 million worth of assets as a result of the termination and distribution.

The new contract will therefore only apply to Mr. Mseleku's exclusive property. If in January 2014, Mseleku decides to marry MaKhumalo (third wife), he will once again be required to make a further application to the High court to amend the existing contract to include his new wife.

Non- compliance with Section 7(6)

In the case of MN V MM[6] the court declared that non- compliance with Section 7(6)of the Act does not render the subsequent marriage void, but results in the marriage being out of community of property. the above situation could result in an unsavoury situation where only the first wife is married in a more beneficial property regime (community of property) while the rest of the wives are out of community of property.

Example

Assuming that Mseleku, in the above example, failed to comply with Section 7(6) before entering into all his three subsequent marriages to MaMyeni; MaKhumalo and MaNgwabe, the marriages themselves would, on the strength of the above decision be valid, but they would be considered

[6] 2012 (4) SA 527 (SCA)

to be out of community of property. Also assume for purposes of this example that there are no children born of the marriages.

Assuming Mr Mseleku dies intestate and at the time of his death, the value of the joint estate I between him and MaCele is R10 million.

1. By virtue of their marriage in community of property, MaCele would be entitled to R5 million (50% of the joint estate)
2. MaCele would also, by virtue of the rules of intestate succession be entitled to a child's share[7] of R1 250 000 (R5 000 000/ 4).
3. The other wives would only receive R1 250 000.

Possible solutions

To prevent the gross inequality which could arise as highlighted in the above example (where the one spouse benefits more than the other because of the applicable marital regime, appropriate life insurance cover payable to the three subsequent spouses, could be a solution to prevent family disputes. Another solution would be for Mr. Mseleku to make intervivos donations of his share of the joint estate to his other wives. The transaction costs of such donations would be minimal since they would not incur any donations tax nor capital gains tax liability.[8] Such a donation would ensure that the value of the donated assets is not included in the calculation of the 'child's share' resulting in a more equitable distribution to the spouses.

Polygamous marriages entered into before 15 November 2000

In terms of Section 7 of the Act (as currently worded) the proprietary consequences of customary marriages entered into before 15 November 2000 continue to be governed by customary law. This means these marriages are governed by often archaic, discriminatory and patriarchal customary laws. The open ended nature of this provision has been exploited to deprive women's ownership of their deceased husbands' assets. [9] It is not a surprise therefore that this section has been the subject of several court challenges.

In the case of Gumede V President of the Republic of South Africa[10], the Constitutional Court declared this section invalid insofar as it related to monogamous customary marriages. The court

[7] A child's portion is calculated by dividing the monetary value of the estate by a number equal to the number of children of the deceased who have either survived him or have died before him but are survived by their descendants, plus the number of spouses.

[8] Section 56(1)(b) of the Income Tax Act and Paragraph 66 of the Eighth Schedule to the Income Tax Act 58 of 1962

[10] (2008) ZACC 23

held that the different treatment between pre and post 15 November 2000 monogamous customary marriages constituted unfair discrimination. The court accordingly held that monogamous customary marriages contracted before 15 November 2000 were in community of property. The court however did not make any pronouncements regarding the validity of Section 7(1) insofar as it applies to polygamous marriages entered into before the commencement of the Act.

The effect of this was that polygamous marriages concluded before the commencement of the Act continued to be governed by discriminatory customary laws, while post- Act polygamous marriages would automatically be out of community of property or be regulated in terms of the written contract as envisaged in Section 7(6).

On 30 November 2017, the Constitutional Court Ramuhovhi and Others V President of the Republic of South Africa and Others[11], confirmed an earlier High Court decision which held that the differential treatment of the proprietary consequence of the pre and post customary polygamous marriages was unconstitutional. The order of invalidity was however suspended to give Parliament an opportunity to amend the Act. The court ordered that, in the interim, wives in pre- Act polygamous customary marriages should enjoy equal ownership rights in the matrimonial property between each of them and their husband.[12]

The court held that in keeping with typical polygamous households, these rights should be exercised as follows:

1. In respect of all house property, the rights should be enjoyed by the husband and the wife of the house concerned, jointly and in the best interests of the family unit constituted by the house concerned; and
2. In respect of all family property (common property), the rights should be enjoyed by the husband and all the wives, jointly and in the best interests of the whole family constituted by the various houses.
3. Each spouse retains exclusive rights to her or his personal property

Example

Mr. Mseleku married his four wives before 15 November 2000. He built four houses for each of his wives. He also built another house which serves as the family home. According to the judgment

[11] (2017) ZACC 41
[12] At para 63

of the court, each wife will enjoy, jointly with Mr. Mseleku equal rights of ownership in respect of her own particular house and the property therein. However, in respect of the family home, the ownership rights vest in all the wives and their husband jointly.

Potential problems which could arise in the above example include the following:

1. On the death of the husband, the total value of his share in all the households and the common property will be included in his estate for estate duty and capital gains tax purposes.
2. If the husband dies intestate, problems would arise in the application of the rules of intestate succession. For example, if Mr. Mseleku dies intestate, then his wives and descendants will become entitled to share in his estate. Depending on the harmony between different families, this could result in protracted family disputes.

Example

Assuming that at the time of Mr. Mseleku death the family portfolio looks as follows:

Property/ House	**Value**	**Number of children in house**
House for MaCele	R 1,000,000.00	1
House for MaMnyeni	R 1,000,000.00	2
House for MaKhumalo	R 1,000,000.00	0
House for MaNgwabe	R 1,000,000.00	3
Common property (Family home)	R 2,000,000.00	
Total	**R 6,000,000**	
Intestate succession rules		
Potential beneficiaries	10 (children plus 4wives)	
Child's share (R6 000 000/10)	R 600,000	
Final payments/ entitlements per house		
MaCele household (R600 000 X 2)	R 1,200,000	
MaMyeni household (R600 000 X 3)	R 1,800,000	
MaKhumalo household (R600 000 X 1)	R 600,000	
MaNgwabe household (R600 000 X 4)	R 2,400,000	
Total	**R 6,000,000**	

From the above example, two potential problems are identifiable:

1. The household with the least number of descendants (MaKhumalo's household) will receive the least share of the estate. The household with the most descendants (MaNgwabe) will receive the lion's share of the estate.
2. All the intestate heirs in the respective families will have concurrent and interlinked claims against the estate. If the relations between the houses are harmonious and the households are amenable to negotiate, they could simply enter into a redistribution agreement to ensure that there are no forced sale of assets. However, if there is conflict between the families, problems could arise if the different intestate heirs refuse to give up their claims. This could result in the forced sales assets to settle these claims. In the above example, if MaNgwabe's family insist on enforcing their claim of R2.4 million, the other households may be forced to sell their assets to satisfy those claims.

A solution in to the above scenario is for Mr. Mseleku to draw up a valid will in terms of which he bequeaths his shares in the respective households in such a way that property belonging to a particular household remains in that family. Another alternative solution would be to create a testamentary trust which will take over ownership of Mr. Mseleku's shares in the event of his death. Life assurance can also be used in this case to ensure that the respective families (in particular the smaller households) receive an equitable share of the estate.

Conclusion

From the above, it is therefore important to consider the following factors before giving advice to clients in polygamous customary marriages:

1. The starting point is to establish when the polygamous marriages were entered into (i.e. if it was before or after 15 November 2000).
2. If the marriages were contracted before 15 November 2000, then the common property is jointly owned and controlled by the wives and their husband.
3. If the marriages were entered into after 15 November 2000, and the husband did comply with the provisions of Section 7(6) all the subsequent marriages will be out of community of property.

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The Accrual Claim at Death vs Divorce

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Introduction

The patrimonial consequences of a marriage are governed by the Matrimonial Property Act[1] which provides for the workings of the various marital regimes applicable under South African law. These patrimonial consequences of a marriage are mostly dealt with on dissolution of a marriage which occurs either on divorce, or on death of one or both of the parties.

One of the martial regimes provided for in South African law is a marriage out of community of property subject to the accrual system[2]. An interesting point to note is that the reason for the dissolution of a marriage subject to the accrual system, i.e. death or divorce, carries different patrimonial consequences for the parties to the marriage.

There are, however, certain patrimonial consequences that are applied in the same manner regardless of the reason for dissolution of the marriage.

This article attempts to explore how the reason for the dissolution of a marriage subject to the accrual system will impact on the patrimonial consequences of the dissolution of the marriage. The article also briefly examines a few instances where the provisions of the Matrimonial Property Act[3] that apply whether divorce or death is the reason for dissolution of the marriage, create an element of uncertainty and where certain provisions of the Matrimonial Property Act[4] are left open to interpretation.

A Marriage subject to the accrual

At dissolution of a marriage subject to the accrual system, the spouse whose estate, or deceased estate, in the event of dissolution of the marriage by death, shows the smaller accrual or no accrual acquires a claim against the other spouse or his deceased estate for an amount equal to half of the difference between the accrual of the spouses' respective estates[5].

[1] Act 88 of1984
[2] The Matrimonial Property Act 88 of 1984 provides that the accrual system will automatically apply to marriages out of community of property entered into after 1 November 1984, For it not to apply, the accrual system must specifically be excluded in the antenuptial agreement
[3] Act 88 of 1984
[4] Matrimonial Property Act 88 of 1984
[5] Section 3(1) of the Matrimonial Property Act 88 of 1984

The accrual of the estate is calculated by deducting the net value of the estate at the commencement of the marriage from the net value of the estate at termination of the marriage.[6] In determining the accrual, the commencement value is adjusted for inflation.[7]

The net value of the estate at commencement of the marriage must be declared in the antenuptial contract (ANC), or within six months of the date of marriage. If not declared, the commencement value will be nil. The commencement value will also be nil if the liabilities of the spouse exceed that spouse's assets at commencement of the marriage.[8]

Exclusions from the Accrual

The Matrimonial Property Act[9] makes provision for certain assets to be excluded from the application of the accrual system, but there is some uncertainty in respect of certain asset types and whether they are to be included or not.

In certain instances, the reason for the dissolution of the marriage dictates whether the asset is to be included in the accrual or not. In other instances, there are specific exclusions that apply to certain assets, but some of the provisions that allow for the exclusion of certain assets are somewhat vague and open to be interpretation.

Provision is made for the following specific exclusions from the accrual of a spouse's estate:

- Assets excluded from the accrual under the ANC as well as assets acquired by virtue of the possession or former possession of such asset;[10]
- Any inheritance, legacy, donation received by a spouse during the marriage as well as assets acquired by virtue of the possession of such asset;[11]
- Donation between spouses[12];
- Any amount that accrued to a spouse by way of damages other than damages for patrimonial loss[13];

[6] Section 4(1) of the Matrimonial Property Act 88 of 1984
[7] Section 4(1)(b)(iii) of the Matrimonial Property Act 88 of 1984
[8] Section 6 of the Matrimonial Property Act 88 of 1984
[9] Matrimonial Property Act 88 of 1984
[10] Section 4 of the Matrimonial Property Act 88 of 1984
[11] Section 5 of the Matrimonial Property Act 88 of 1984
[12] Section 5 of the Matrimonial Property Act 88 of 1984
[13] Section 4(1)(b)(i) of the Matrimonial Property Act 88 of 1984

A question that may arise is whether the proceeds of a policy that pay out as a lump sum on the disability of the life assured or on the life assured being diagnosed with a dread disease, are to be regarded as patrimonial loss or not.

The question relating to a dread disease was addressed in van Dyk v van Dyk[14] where the court ruled that proceeds of a policy that insure against an event that affects what is referred to as 'highly personal interests'[15] of the insured, that are paid out as a lump sum are to be regarded as non-patrimonial damages and are not to be taken into account in determining the accrual of an estate. The exclusion of such proceeds also extends to the fruits of such proceeds. One of the arguments in this regard was that the policy proceeds were not to replace the income or income earning ability of the life assured.

From van Dyk v van Dyk[16]I one can deduce that f the damages received are regarded as damages 'other than damages for patrimonial loss' they will be excluded from the accrual. [17]

The court makes it clear that he proceeds of a dread disease policy will fall within what is described in the case[18] as a pay-out that is for 'the exclusive benefit of the life assured because of pain and suffering that will be endured into the future' and is not paid as compensation for the life assured's inability to earn an income.[19]

The ruling did not make any reference to lump sum or income disability claims. It appears to be a grey area and one can argue that it could depend on the facts of a particular case. It could, for example, be argued that a pay-out that replaces the income or earnings potential of the life assured is of a patrimonial nature and should be included in the accrual claim, whereas a pay-out that relates to the 'highly personal interests' of the lie assure should be regarded as non-patrimonial in nature and should thus not be included in the accrual claim.

Retirement funds are often treated incorrectly when determining the accrual of a person's estate. The Divorce Act[20] provides clarity in that it specifically deems a party's pension interest to be part of the relevant spouse's assets for purposes of establishing the spouse's patrimonial entitlements.

[14] Van Dyk v van Dyk (945/2007) ZAFSHC17
[15] Van Dyk v van Dyk (945/2007) ZAFSHC17
[16] Van Dyk v van Dyk (945/2007)ZAFSHC17
[17] A patrimonial loss is a reduction in a person's financial position, i.e. a tangible financial loss
[18] Van Dyk v van Dyk (945/2007) ZAFSHC17
[19] Van Dyk v van Dyk (945/2007) ZAFSHC17
[20] Section 7 (7)(a) of the Divorce Act 70 0f 1990

Section 37C(1) of the Pension Fund Act[21] provides that, regardless of the provisions of any other law, all death benefits payable by the fund on the death of a member shall not form part of the assets of the estate of such member.[22] The value of a retirement fund is thus not taken into account for purposes of the accrual claim.

Life policies are only relevant at dissolution of a marriage by death of the life assured since the benefit is only due and payable by the insurer at death of the life assured.

The question that arises at dissolution of the marriage subject to the accrual system by death, is whether the proceeds of a life policy are to be included in the accrual of the deceased's estate or not.

Where there is a beneficiary on a life policy, the policy proceeds are not included in the accrual of the deceased's estate. However, where there is no beneficiary nominated on the policy, the policy proceeds pay to the estate of the deceased and are therefore included in the accrual of the deceased life assured's estate.

Note that where the deceased party's spouse is the contracting party on a life policy on the deceased's life, the proceeds of such a policy will be included in the accrual of the surviving spouse's estate.[23] I think the Premiums & Problems on page E56.

It is also noteworthy that assets that are transferred to a legitimate trust, where one would assume that such assets would be excluded for purposes of the accrual, may be included in the assets of the transferor where it can be shown that the purpose of the transfer of the assets was to intentionally deny the other spouse any accrual in such asset.

Application of the accrual system at dissolution of the marriage at divorce v death

As stated above, the reason for the dissolution of a marriage subject to accrual system impacts the patrimonial consequences of the dissolution for each party. This impact is best explained by way of an example where the same facts are used to illustrate the accrual claim calculation at divorce versus the accrual claim calculation at death

[21] Pension Fund Act 24 of 1956
[22] The Pension Funds Act No 24 of 1956
[23] Premiums and Problems Edition 117, page E56

Mr and Mrs Vettel were married subject to the accrual system in May 1990. Mr Vettel had a commencement value of R100 000 declared in their ANC. The ANC contained a clause stating that the shares in Seb (Pty) Ltd were to be excluded from the accrual. Mrs Vettel did not declare a starting value.

In March 2012 the couple's assets and liabilities were as follows:

Mr Vettel:

Property worth R900 000

Retirement fund worth R850 000

100% Shares in Seb (Pty) Ltd valued at R1 200 000

Bond from MERC Bank of R200 000

Boat valued at R60 000 (purchased with proceeds from sale of boat inherited from dad)

R65 000 – cash received for pain and suffering from ex business partner

Mrs Vettel's assets and liabilities were as follows:

Holiday home inherited from her late uncle worth R750000

Investment portfolio of R150 000 received as donation from her spouse

Endowment policy: R190 000 fund value with her son as beneficiary and Mrs Vettel as the life assured

Life policy: R900 000 with no beneficiary

Calculation of accrual at divorce, assuming divorce in March 2012:

Value of Mr Vettel's assets at divorce		R3 075 000	
Property	R900 000		
Retirement fund	R850 000		
100% Shares in Seb (Pty) Ltd	R1 200 000		
Boat	R60 000		
Cash	R65 000		
Less liabilities (bond)			R200 000
Less assets excluded from accrual		R1 325 000	
100% Shares in Seb (Pty) Ltd	R1 200 000		
Boat	R60 000		
Cash	R65 000		

Less commencement value revalued at CPIX		R463 210	
CPIX May 1990 = 26.1			
CPIX March 2012 = 120.9			
❑ 120.9/26.1 = 4,6321			
❑ R100 000 x 4,6321			
Net accrual: Mr Vettel		**R1 086 790**	
Value of Mrs Vettel's assets at divorce		R1 090 000	
Holiday home	R750 000		
Investment portfolio	R150 000		
Endowment policy	R190 000		
Less assets excluded from accrual		R900 000	
Holiday home	R750 000		
Investment portfolio	R150 000		
Net accrual: Mrs Vettel		**R190 000**	
Divisible accrual	**R1 086 790 – R190 000**	**R896 790**	
Accrual claim at divorce in favour of Mrs Vettel		**R448 395**	

If we assume that Mr Vettel died in March 2012.

Value of Mr Vettel's assets at death	R2 225 000	
Property		R900 000
100% Shares in Seb (Pty) Ltd		R1 200 000
Boat		R60 000
Cash		R65 000
Less liabilities (bond)		R200 000
Less assets excluded from accrual		R1 325 000
100% Shares in Seb (Pty) Ltd		R1 200 000
Boat		R60 000
Cash		R65 000

Less commencement value revalued at CPIX	R463 210	
CPIX May 1990 = 26.1		
CPIX March 2012 = 120.9		
❑ 120.9/26.1 = 4,6321		
❑ R100 000 x 4,6321		
Net accrual: Mr Vettel		**R236 790**
Value of Mrs Vettel's assets at death		R1 8000 000
Holiday home		R750 000
Investment portfolio		R150 000
Life policy		R900 000
Less assets excluded from accrual	R900 000	
Holiday home		R750 000
Investment portfolio		R150 000
Net accrual: Mrs Vettel		**R900 000**
Divisible accrual R900 000 - R236 790		**R663 210**
Accrual claim at divorce in favour of Mr Vettel		**R331 605**

The above calculations clearly show that, in these circumstances, the result of an accrual calculation at divorce differs significantly from the accrual calculation at death. At divorce there is an accrual claim in favour of Mrs Vettel, but at death the accrual claim is on favour of Mrs Vettel.

Settling the accrual claim

At dissolution of the accrual marriage at divorce, the only option to settle the claim is to use existing assets of the estate of the spouse with the greater accrual. Where these assets are assets subject to capital gains tax, this gives rise to a potential capital gains tax liability.

In terms of Paragraph 67 of the Eighth Schedule of the Income Tax Act[24] a person is treated as having disposed of an assets to his/her 'spouse'[25] if that asset is transferred to that spouse in consequence of a divorce order.

[24] Act 58 of 1962
[25] Section 1 of the Income Tax act 58 of 1962

Practically, this means that where a spouse transfers assets to his/her ex-spouse in consequence of a divorce order, the capital gains tax liability that arises as a result of the disposal rolls over to the ex 'spouse'. When the 'ex-spouse' disposes of the asset, the base cost will thus be the base cost of the 'ex-spouse' from whom the asset was received.

Since the capital gains tax liability is deferred until the recipient 'ex-spouse' disposes of it, there is no tax that is due and payable at date of dissolution of the marriage and accordingly no liability that arises that would have the effect of reducing the accrual claim.

In the event of dissolution of the accrual marriage by death, the accrual claim can also be settled by using the existing assets of the spouse with the greater accrual. This also gives rise to a disposal for purposes of capital gains tax but since the asset is a disposal to a surviving spouse[26] the capital gains tax will also roll over to the surviving spouse.

If the accrual claim is to be settled in cash and there is no liquidity in the estate to fund this, or where assets of the deceased's estate need to be sold to generate liquidity to cover estate costs, or where capital assets are bequeathed to third parties, the disposal of these assets to generate this liquidity or give effect the testamentary wishes of the deceased, will result in a capital gains tax liability for the deceased estate. This liability will reduce the amount of the accrual claim[27]

Where the surviving spouse inherits the residue of the deceased estate, the overall benefit received by the surviving spouse (i.e. accrual claim and residue) will be reduced by the full value of the capital gains tax payable by the deceased estate[28] sine the accrual claim is reduced by 50% of the capital gains tax liability and the residue is residue is reduced by the remaining 50% of the capital gains tax liability.

Where the surviving spouse does not inherit the residue, he/she indirectly pays one half of the capital gains tax liability in the estate – the indirect payment is as a result of the reduction of the accrual claim.

The potential impact of capital gains tax on the accrual claim that arises at dissolution of a marriage by death is often overlooked.

[26] Section 1 of the Income Tax Act 58 of 1962
[27] Accrual claim and CGT; who really pays the CGT?', Marius Botha
[28] Accrual claim and CGT; who really pays the CGT?', Marius Botha

With careful estate planning, however, an additional option available to spouses married subject to the accrual system is to be proactive and provide for the settlement of the accrual claim at death with the proceeds of a life policy on the life of the spouse with the greater accrual in their estate.

It must be borne in mind that the policy proceeds of such policy will further increase the value of the accrual in the estate of the life assured. Provision will thus need to be made for the value of the accrual claim calculated prior to the inception of the policy, and the amount by which the accrual claim has increased as a result of the new policy that is taken out to fund the accrual claim.[29]

Conclusion

As has been illustrated above, there is a difference in which assets are included in the accrual of a spouse's estate where the marriage subject to the accrual is dissolved by way of death as opposed to where the marriage is dissolved by divorce. The potential impact of capital gains tax on the accrual claim in these two scenarios also differs. Some uncertainty exists as to whether certain assets fall within the general exemptions in respect of assets that are specifically excluded from the accrual of a marriage.

At divorce, all assets, other than assets specifically being excluded from the accrual as provided for in the Matrimonial Property Act[30], are included in the spouse's estates for purposes of calculating the accrual claim. The only possible way to limit value of the accrual claim that may arise at divorce is the legitimate transfer or purchase of assets into a discretionary trust.

At death, where the residue of a spouse's estate is bequeathed to the surviving spouse, the accrual calculation is purely academic. The potential impact of capital gains tax, however, needs to be considered.

However, where assets are bequeathed to a party other than the surviving spouse, the accrual claim is a critical part of the process of winding up of the estate. Effect cannot be given to the deceased's testamentary wishes until the patrimonial consequences of the marriage, i.e. the

[29] Accrual claim and life insurance revisited, Marius Boths
[30] The Matrimonial Property Act 88 of 1984u

settlement of the accrual claim in favour of either the deceased or surviving spouse's estate, has been finalised.

The accrual claim needs to be reviewed as part of an estate planning exercise for a client, especially since the accrual claim at death can be limited by not only the legitimate transfer of assets to a trust, but by simply nominating a beneficiary on a life policy or by investing capital in a retirement annuity. The accrual claim, at death, can also be provided for by way of life cover, which is not an option on divorce.

There are certain instances, such a life assured receiving a lump sum disability benefit where the courts have had to interpret whether such benefit is patrimonial or non-patrimonial in nature. There is uncertainty regarding whether income replacement pay-outs are of a patrimonial or no-patrimonial nature. It would appear that each case will depend on the facts and whether the pay-out is intended to provide for loss of future income and earning capacity which, it is contended, be patrimonial in nature.

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