SOME CLARITY ON THE ACCRUAL OF LIVING ANNUITIES AT DEATH OR DIVORCE

CM v EM (1086/2018) [2020] ZASCA 48; [2020] 3 All SA 1 (SCA); 2020 (5) SA 49 (SCA) (5 May 2020)

1 Introduction

A conventional life annuity is a contract in terms whereof an annuity underwriter guarantees a periodical payment to an insured in exchange for an initial non-refundable premium. The insurer pools all the annuity premiums together and assumes both the investment performance and the mortality risk by way of actuarial comparisons (see Bester *Comparing Five Annuity Options Offered at Retirement in South Africa* (MComm dissertation, University of Stellenbosch) 2016 34–35). The annuitant's income is guaranteed for life or for a minimum period.

Living annuities on the other hand are regulated by the Long-Term Insurance Act 52 of 1998 and are market-linked investments (with no income guarantee) in respect of which the annuitant annually chooses the drawdown rate – currently between 2.5 and 17.5 per cent per annum (compare Regulations in terms of s 36 of the Pensions Act 24 of 1956 and s 106(1)(*a*) read with s 108(1) of the Financial Sector Regulation Act 9 of 2017.) When an annuitant dies, the death benefit is payable to a nominated beneficiary or the estate of the insured (see https://www.actuarialsociety.org.za and https://www.isasapensionfund.co.za (accessed 2021-04-25)). A pension-interest benefit is an asset for the purposes of the division of an estate at divorce, and includes both pension and provident funds (see s 7(7) and (8) of the Divorce Act 70 of 1979 and s 37D(4)(*a*) and (*d*) of the Pension Funds Act 24 of 1956; *GN v JN* 2017 (1) SA 342 (SCA)). Living annuities, however, do not fall within the definition of "pension interest" as defined in s 1 of the Divorce Act (see *Nailana v Nailana* 714/2018 [2019] ZASCA 185 (3 December 2019) for an interpretation of the term "pension fund"; De Klerk "Clarifying the Term Pension Fund in the Divorce Act and the Pension Fund Act" July 2020 *De Rebus* 25; see *Old Mutual Life Assurance Co (SA) Ltd v Swemmer* 2004 (5) SA 373 (SCA) par 8 on the term "pension interest").

In *CM v EM* ((1086/2018) [2020] ZASCA 48; [2020] 3 All SA 1 (SCA); 2020 (5) SA 49 (SCA) (5 May 2020)), the Supreme Court of Appeal, in an appeal from the full court of the Gauteng Division of the High Court, sitting as court of appeal, had the opportunity to determine where the ownership of capital invested in the form of a living annuity vests, as well as whether the value of an annuitant spouse's right to future annuity payments is an asset in his or her estate and therefore subject to accrual. Accrual in respect of an estate is the amount by which the net value of the estate at the dissolution of a marriage exceeds the net value of that estate at the commencement of the

marriage (see s 4 of the Matrimonial Property Act 88 of 1984). At the dissolution of a marriage owing to death and subject to the accrual system, the spouse whose estate shows no accrual, or a smaller accrual than the estate of the other spouse, has a claim against the other spouse or his or her deceased estate (see s 3(1) of the Matrimonial Property Act; *N v G* 2018 (4) SA 316 (WCC); Lotter "Estate Planning: The Inclusion of the Proceeds of a Life Policy When Accrual is Calculated" 2013 *Journal for Juridical Sciences* 38–57).

It is submitted that some implications of the accrual dispensation, particularly within the context of certain pension and financial products, are still in their discovery phase, nearly 40 years after their introduction (see Muller "The Treatment of Life Insurance Policies in Deceased Estates with a Perspective on the Calculation of Estate Duty" 2006 69 *THRHR* 259–278.) In the absence of any reference to a living annuity in an antenuptial contract, the question was always whether such an investment is subject to the accrual system at divorce or death. In the context of a life assurance policy, the surrender value of the policy was taken into account in the event of divorce, but in the event of death, the question was whether, for accrual purposes, the factor taken into account should be the surrender value or the policy proceeds. (Muller 2006 *THRHR* 270 submits that in the case of a marriage out of community of property that is subject to accrual, the policy benefits must be valued at the moment of death, which approach will be consistent with the result achieved in the case of a marriage in community of property.)

As only assets that form part of the estate of a spouse can be considered for accrual purposes, the very nature of a living annuity had to be investigated in the matter of *CM v EM* (*supra*). This case was an application for special leave to appeal from the full court in the matter of *Emilio Pietro Valfredo Montanari v Charmaine Helen Montanari (Montanari v Montanari*).

2 *Montanari v Montanari* ZAGPJHC (unreported) 2016-08-10 Case no 14/26868

The Montanaris were married out of community of property with inclusion of the accrual system. The respondent used his pension benefits to purchase three living annuities during the duration of the marriage and sought a declaratory order that these annuities should not be regarded as assets in his estate for the purposes of calculating the accrual in his estate. The parties agreed during the trial that the living annuities did not qualify as a pension interest as defined in s 1 of the Divorce Act and that the court needed first to decide, before the merits of the action could be determined, whether the living annuities acquired by the respondent formed part of his estate. The respondent's case was that the living annuities were also not subject to accrual, as the ownership of the capital was vested in the insurer, with the investor only being entitled to the annuity income (par 6) (see General Note 18 of General Notes Second Schedule to the Income Tax Act 58 of 1962, Issue 2, with effect 1 September 2008, on providing annuities on retirement).

Victor J accepted this version, but concluded that it was permissible for the annuity income to be taken into account in the future for the determination of maintenance needs (par 30). A benefit valuation actuary for the applicant testified that although he could not give an opinion on the actual ownership aspect, it was possible to place a market value on the respective income streams generated by the living annuities (par 24). This decision was taken on appeal to the Gauteng Division of the High Court before Keightley and Modiba JJ and Sardiwalla AJ. However, before the appeal to the full court was heard, judgment was delivered in *ST v CT* ((1224/16) [2018] ZASCA 73; [2018] 3 All SA 408 (SCA); 2018 (5) SA 479 (SCA) (30 May 2018)), where it was found that the annuities belonged to the insurer and not the annuitant. The applicant on appeal accepted the legal position and did not tender any new considerations, resulting in a confirmation by the full court of the decision by Victor J that the respondent's living annuities did not form part of his estate for the purposes of accrual.

3 *ST v CT*

The case of *ST v CT (supra)* was an appeal to the Supreme Court of Appeal (SCA) from the court of first instance (Weinkove AJ in the Western Cape Division), resulting from a bitterly contested divorce trial in which the value of the accrual in the appellant's estate had to be determined. Owing to the complexity of the appellant's estate and business structures, as well as his lack of cooperation, the court admitted that it would never be able to establish the exact value of his estate as at the time of the divorce (par 49). One of the contentious findings by the court *a quo* was that a particular living annuity had to be included as an asset in the appellant's estate for purposes of calculating the accrual (par 112). The SCA referred to the rejection of the contention that a living annuity fell within the annuitant's estate in the court of first instance in the *Montanari* case and was thus confronted with two opposite views by the High Court in different divisions on the novel question of whether a living annuity upon divorce forms part of the accrual. The court observed that the High Court matter before Victor J in *Montanari* was to its knowledge the only decision where the question under discussion had been dealt with in full (par 102 and 104).

A living annuity is in essence defined as the right of a member of a retirement fund to an annuity purchased from the fund on or after the retirement date of the member (see s 1 of the Income Tax Act 58 of 1962, read with GN 290 in *GG* 32005 of 2009-03-11). The definition continues to set certain requirements with which all living annuity contracts must comply. When an annuitant purchases a living annuity, he or she is no longer a member of a pension fund organisation, as the termination of all interests in the relevant retirement annuity fund took place when the funds were used to purchase the living annuity (see par 106–107). This is not unique to living annuities, as both life annuities and living annuities result in termination of the interest that the annuitant had in the retirement annuity fund.

By its nature, the capital value of a living annuity does not belong to the annuitant, but to the insurance company (par 108). The annuitant's contractual right is to be paid an annuity selected by him or her within the permissible range specified by the applicable legislation. *In casu*, the court

refrained from determining whether the conditional right of the annuitant to future annuity payments was an asset in his estate. The court did, however, make clear, albeit obiter, that the value of the annuitant's right could not be equated to the value of the capital, but had to be determined by the annuitant's life expectancy and the rate of past and future drawdowns from the annuity (see par 110; compare the life-expectancy table issued under GN R1942 in *GG* 5746 of 1977-09-23 under s 29 of the Estate Duty Act 45 of 1955).

4 *CM v EM*

CM v EM (supra) was an application for special leave to appeal in which the applicant challenged the judgment of the full court in the *Montanari* matter, which had affirmed the decision in *ST v CT* (*supra*) that the annuitant's living annuities did not form part of his estate for purposes of calculating an accrual. The applicant, relying on *Commissioner, South African Revenue Service v Higgo* (2007 (2) SA 189 (C)), raised a number of contentions on appeal, arguing that if the SCA had had the benefit of considering those aspects in *ST v CT*, it would not have found that the annuities belonged to the insurer. In the *Higgo* case, it was held that the provider of the living annuity was not the beneficial owner of the capital. In the case in hand, however, the court found that *Higgo* was not applicable, as in that matter the court was not dealing with a living annuity, but with a life annuity, before the current definition of living annuities was introduced into the Income Tax Act in 2008 (par 27 and 28). The court explained in detail the difference between living annuities and conventional life annuities (par 23 and 24).

The court agreed that living annuities were contracts complying with the requirements of the Income Tax Act and that neither the proceeds nor the annuity income fell within the ambit of "pension interest" as defined in the Divorce Act (par 22). The court agreed with the judgment in *ST v CT* (*supra*) that the capital of the living annuities belonged to the respective insurers and the client's only contractual right was to be paid an annuity in an amount by instalment (par 38). The annuitant had the right to direct into which investments the capital had to be placed, to nominate beneficiaries, and to further determine annually the level of income and the frequency of payment – within the pre-defined parameters set by ministerial regulation (par 21).

With analogy to the position of a right to a pension, the court supported the decision in *De Kock v Jacobson* (1999 (4) SA 346 (W)), in which it was decided that both the cash component and the accrued right to the pension that vested in a spouse in a marriage in community of property did qualify as an asset in the joint estate of the parties (par 37) (see *De Kock v Jacobson supra* 349G; compare further *Clark v Clark* 1949 (3) SA 226 (D), in which it was accepted that a spouse's interest, both in a pension that had accrued and in one that had not yet accrued, would form part of the communal estate, as well as *Commissioner for Inland Revenue v Nolan's Estate* 1962 (1) SA 785 (A) 791C–E, reaffirming that the right to a pension right that vests in the parties in a marriage in community of property vests in undivided shares; see Hands, Cloete, Slater, Muller and Peter 2016 113 *Premiums and Problems* C8 for a comparison between different retirement vehicles).

The court in *CM v EM* (*supra*) further determined that the relationship between the insurer and the annuitant was "purely contractual in nature", and did not create a fiduciary relationship between the parties (par 33). The insurer's obligation to the annuitant was limited to the payment of the stipulated annuity. The annuity, and not the capital, became an asset on the balance sheet of the annuitant (par 31–34). The question was whether the right to an annuity could consequently be regarded as an asset in the estate of the annuitant, and whether such an asset could be taken into consideration when determining accrual.

Supporting *ST v CT* (*supra*), the court in *CM v EM* (*supra*) confirmed that the respondent had a "clear right" to investment returns yielded by the capital invested in an annuity product that would give him an income in future. It was decided that the annuity was "evidently an asset which can be valued", as presented in evidence before the court (par 38). The main difference was that the trial court considered the annuity income as being relevant only for the determination of a maintenance claim, while the SCA found it to be an asset in the respondent's estate (par 38). If the annuity income is an asset in the estate of a spouse married out of community of property with inclusion of accrual, it should be taken into consideration in determination of the accrual claim between the parties.

The appeal was upheld with costs and the value of the respondent's right to future annuity payments had to be taken into account in calculating the accrual in his estate (par 39).

5 The impact of the SCA decision

The full bench of the High Court in *CM v EM* (*supra*) affirmed the trial court's decision on the strength of the judgment in *ST v CT* (*supra*) that the living annuities did not form part of the respondent's estate for purposes of calculating the accrual. The SCA had to decide in *CM v EM* (*supra*) on the question left open in *ST v CT* (*supra*) – namely, whether a married annuitant's right to future annuity payments is an asset that can be valued for accrual purposes. *CM v EM* (*supra*) confirmed the legal nature of living annuities as decided in *ST v CT* (*supra*), adding that the capital is vested in the insurer and not in the annuitant (par 28 and 37). The characterisation of a living annuity as actually consisting of two distinguishable monetary parts, namely the capital value and the income stream, was an important development. The SCA further acknowledged, both in *ST v CT* (*supra* par 109–112) and in *CM v EM* (*supra* par 31), that the annuitant had a contractual right to the future income stream and that this right was both identifiable and quantifiable. A contractual right is established, irrespective of whether it is a living annuity or a life annuity. The importance of the legal certainty brought by these cases – particularly *CM v EM* (*supra*) – must not be underestimated. Although both matters dealt with accrual during divorce, the principle is extendable to deceased estates (see Meyerowitz *The Law and Practice of Administration of Estates and their Taxation* (2010) 15.48). Except for the reference to life expectancy and the drawdown rate in *ST v CT* (*supra*), the courts did not give an indication on how the value of the future annuity should be determined (par 110).

6 How to determine the value of a living annuity

Although the court soberingly accepted in *ST v CT* (*supra*) that it was not able to establish the exact value of the appellant's estate as at the time of divorce, it still had a duty to determine *a* value to the best of its ability (par 49). In this context, the court referred to Mostyn J in *NG v SG* [2011] EWHC 3270 (Fam) (UK), stating that, at the least, the court had to "attempt a realistic and reasonable quantification of those funds, even in the broadest terms" (par 16). One must accept that the determination of the value of a future income stream will never be an exact process, but it is of importance to legal practitioners in cases of divorce and for financial and estate planners in advising clients properly. Executors of deceased estates in particular are confronted with determining the value of living annuities when liquidation accounts are prepared for estates where the deceased person was married in community of property or with inclusion of the accrual dispensation, or where a maintenance claim is instituted by the surviving spouse. (The Matrimonial Property Act contains no provision as to how the value of any asset of an estate is to be determined; compare Meyerowitz *Administration of Estates* 15–29 and 29–4.) The standard formula in calculating the present value of an annuity takes into consideration a number of factors based on particular facts or well-considered assumptions. In this case note, the focus is particularly on the formula to be used in determining an accrual claim where the living annuity is an asset in a deceased estate. (The living annuity may also be part of the estate of the surviving spouse, in which case the life expectancy of the survivor will be applicable.) In determining the net present value of the income stream, the following factors are to be considered: the estimated inflation rate over the period, the discount rate, the elected percentage income to be taken and the life expectancy of the annuitant. Each of these factors can be debated, but the executor will have to make certain defendable assumptions (see Boshoff "Valuing Living Annuities" March 2021 *De Rebus* 40–42).

When determining the applicable inflation rate, the latest published rate can be used, but it may be more appropriate to apply the average of the inflation target band set by the South African Reserve Bank, as that should be a better indicator of future economic realities (see Boshoff 2021 *De Rebus* 41; inflation-targeting by the South African Reserve Bank was instituted in the early 2000s in an attempt to create price stability and certainty, with the objective being to keep consumer price inflation at around 4.5%). Using the 10-year government bond rate to reduce a future value to a present value is the closest to using a so-called risk-free rate of return. The following factors must be considered when determining a discount rate: the required nominal return of the investor, the anticipated inflation rate during the investment period, and what compensation the investor should seek for the risk (see https://www.investopedia.com/terms/r/risk-freerate.asp (accessed 2020-07-27)). There must be good motivation for deviating from the annual withdrawal rate elected by the deceased during his or her lifetime – and in particular the last chosen drawdown rate. In the absence of such election exercised by the deceased, it would be prudent to consult with an experienced financial advisor in determining an acceptable rate. It is submitted that the annuitant's life expectancy on the day before his or her

demise, as per the most recently published actuarial tables, should be applied (see https://www.statssa.gov.za/publications/P0302/P03022019.pdf (accessed 2020-06-30)). Lastly, it is submitted that the most appropriate method to use for an annuity that is paid annually is to do the calculation on an annual basis, in advance (compare Hands *et al* 2016 *Premiums and Problems* F34–F36).

It is submitted that the following formula may be used to determine the present value of a growing annuity due (see https://xplaind.com/960274/growing-annuity-pv-fv (accessed 2020-07-28), adapted for the purposes of this article by Riaan Strydom CFP®, a wealth advisor at PSG Wealth in Port Elizabeth):

$$PV_{GAD} = \frac{C}{r-g} \times \left(1 - \left(\frac{1+g}{1+r}\right)^{n}\right) \times (1+r)$$

PV_{GAD} = present value of future annuities
C = annual annuity
r = discount rate (e.g., the 10-year government bond rate)
g = escalation rate of the income (e.g., the inflation rate)
n = total number of cash flows (determined by the life expectancy of the annuitant)

The practical application of the formula can be illustrated in the following example. The deceased is a male person, 70 years of age, and married in terms of the accrual dispensation. His life expectancy the day before his death was 9.37 years. The capital value of his life annuity is R5 000 000.00. The withdrawal rate at his death is 5 per cent. CPI is 4,5 per cent and the R186 bond rate is 9,5 per cent. The resulting value of the income stream to be taken into account for accrual purposes is R1 750 000.00.

7 Conclusion

Ever since the introduction of the accrual dispensation, questions have been asked about the rights of spouses to pension funds, mostly in matters of divorce. These have resulted in significant amendments to both the Divorce Act and the Pension Funds Act. (The Divorce Act was amended by Act 7 of 1989 and the Pension Funds Act in 2007 with the introduction of s 37D. In *MN v FN* (714/2018) [2019] ZASCA 185 par 25, it was determined that a reference to a right and interest in a pension fund included both the pension fund and the provident fund. (See *Old Mutual Life Assurance Co (SA) Ltd v Swemmer supra* par 5–8 for more on the ambit of s 7(7) and (8) of the Divorce Act.) The most important change was to determine legislatively that the pension interest of the spouse of a pension fund member is regarded as an asset in his or her estate (see *De Kock v Jacobson supra* 349G–H for the watershed decision in this regard; compare Marumoagae “A Non-Member

Spouse's Entitlement to the Member's Pension Interest" 2014 17(6) *PER/PELJ* 2014).

It is a basic principle that the assets of a joint estate belong in equal shares to the spouses; and the assets in the estate of a spouse married with accrual are taken into account when the accrual calculation is done, except if they fall within one of the legislative exclusions (see *Rosenberg v Dry's Executor* 1910 AD 679; *BF v RF* (2017/5018A) [2018] ZAGPJHC 699; see s 5 of the Matrimonial Property Act for exclusions from accrual.) It is also important to consider s 37C of the Pension Funds Act that deals with the distribution of lump sum benefits at the death of a member. The courts sometimes, unfortunately, compare the division of a pension interest with that of spousal maintenance, as in *Sempapelele v Sempapelele* (2001 (2) SA 306 (O) 312G–H). This was correctly rejected in *Ndaba v Ndaba* ((600/2015) [2016] ZASCA 162; [2017] 1 All SA 33 (SCA); 2017 (1) SA 342 (SCA) (4 November 2016) par 15–28; see Van Schalkwyk "Wanneer Vind Artikel 7(7) van die Wet op Egskeiding 70 van 1979 Toepassing?" 2013 46(3) *De Jure* 849; Pienaar "Does a Non-Member Spouse Have a Claim on Pension Interest?" Dec 2015 *De Rebus* 38). Pension interests should also not be confused with annuities regulated by the Long-Term Insurance Act (ss 37 and 63). A clear distinction is necessary between the question whether an asset forms part of an in-community or with-accrual estate, versus taking a pension fund or annuity into account in the determination of a right to maintenance.

The decision in *ST v CT* (*supra*) came very close to acknowledging that the contractual right to an annuity is an asset in the estate of the annuitant. The court unfortunately referred to this right as a "conditional right" and further equated the contract between the annuitant and the insurer with the capital value of the annuity (par 110 and 112). This was confusing, as the court acknowledged the right of the annuitant to income in terms of the same contract (par 108). It is submitted that both the High Court and the SCA erred in that they equated the contract with the capital of the annuity contract. However, it is clear that the annuity contract has two very distinct values – namely, the capital value of the annuity and the contractual right of the annuitant to receive an annual payment.

It is reassuring that in *CM v EM* (*supra*) the SCA clarified the legal nature of living annuities, including that the capital in annuities is no longer accessible to the annuitant and actually vests in the insurer. Furthermore, the annuity income does not fall within the ambit of "pension interest" as defined in the Divorce Act (par 22). With this decision, living annuities will be treated in future in terms of their true nature, which will make it more difficult for annuitants to use annuities to hide funds from their spouses (or make them inaccessible) at the termination of marriage. That the value of the annuity is not only used as a factor when a maintenance claim is considered, but actually forms part of the estate of the annuitant, is a major breakthrough and will result in a fairer distribution of assets at divorce or death. Clear direction on these matters was long overdue.

In *CM v EM* (*supra*), the court further differentiated between living annuities and so-called "conventional life annuities", which, according to the court, are fund-owned and purchased from an insurer by the fund on behalf

of the member, and they pay a guaranteed monthly pension until the death of the annuitant (par 23). It seems as if the court was not aware that not all life annuities are necessarily fund-owned; they may also be member-owned. Life annuities are purposed to provide insurance against longevity and investment risk, with the annuity ceasing at the death of the annuitant and the capital, if any, being forfeited. The risk of the capital being lost at the death of the annuitant can be insured against by the purchase of an additional insurance policy (see Benecke "What to Consider Before Choosing Between Living Annuity or Guaranteed Annuity for Retirement" 25 March 2020 Biznews https://www.biznews.com/wealth-advisors/2020/03/25/retirement-living-guaranteed-annuity (accessed 2020-07-22)).

It is unfortunately not clear from the *CM v EM* (*supra*) judgment whether the court is of the opinion that life annuities and living annuities should be dealt with differently. The statement that fund-owned life annuities "are completely different from ... member-owned living annuities" (par 23), as well as the apparent confusion in the *Higgo* case (meaning that it is not authoritative in the current matter (par 28)), may leave one with the impression that the principles applied to living annuities in this case are not necessarily applicable to life annuities. It is submitted that such inference would be unfortunate, as the convincing factor should not be the ownership of the annuity but the right of the annuitant. To treat the contractual rights of annuitants of life annuities any differently would fly in the face of the rationale followed by the court and may result in financial advisors identifying this as a new arbitrage opportunity. The real question is not the origin of the right, but whether there is indeed a right to income that can be regarded as an asset in the annuitant's estate.

Although most reported matters in this area have dealt with divorce, the case of termination of marriage by death is equally important. Fiduciary advisors and financial planners must take note of this important decision and determine how it will impact a client's estate plan as well as his or her final wishes. Although freedom of testation is a fundamental principle of the South African law of wills and is constitutionally guaranteed, it must be exercised within a framework of fairness (see *Minister of Education v Syfrets Trust Ltd* 2006 (4) SA 205 (C) par 48; Lehman "Testamentary Freedom Versus Testamentary Duty: In Search of a Better Balance" 2014 *Acta Juridica* 9).

This case comes as a relief and a balancing agent in a legal system of strict testamentary freedom, where the election of an appropriate marital property regime and the right to maintenance are the two most important protection mechanisms for the spouse who has less opportunity to grow his or her estate. (Protection mechanisms are included in the Maintenance of Surviving Spouses Act 27 of 1990, the Pension Funds Act and the Matrimonial Property Act. See Gordon "How a Court Ruling Will Change Living Annuities in Divorce Cases" (15 May 2020) https://www.iol.co.za/personal-finance/how-a-court-ruling-will-change-living-annuities-in-divorce-cases-47923306.

The case will also result in a fairer treatment of financially vulnerable spouses where life annuities have previously been deliberately used to exclude a spouse from an inheritance. The development brought about by

the *CM v EM* case should be welcomed by everyone in support of substantive justice between spouses. It is hoped that this case will serve as an example of how law can develop in an accountable and just manner without unwarranted attacks on common-law principles such as freedom of testation (see the approach by Victor AJ in *King NO v De Jager* (CCT 315/18) [2021] ZACC 4; 2021 (5) BCLR 449 (CC) (19 February 2021) par 244).

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