CASES / VONNISSE

WHEN IS AN ANNUITY NOT AN ANNUITY?

Cape Tax Court (ITC 1797 (2005) 67 SATC 377)

1 Introduction

The decision of the Cape Tax Court in ITC 1797 (2005) 67 SATC 377, upheld on appeal by a full bench of the Cape High Court *sub nom CSARS v Higgo* (2006) 68 SATC 278, throws new light on the nature, for tax purposes, of an "annuity" and the taxability of the returns on an amount invested by a person in a typical so-called "living annuity".

The usual terms of a "living annuity" – as exemplified by the facts of this case – are that the investor pays a financial institution a lump-sum and, in return, is entitled to withdraw, in each year, not less than 5% and not more than 20% of the amount invested, until such time as the capital amount and interest is exhausted. If any capital remains when the investor dies, then his rights to the residue pass to his heirs, who can withdraw in the same way until the capital and interest have been exhausted.

In this case, SARS argued that the monthly amounts paid to the taxpayer in terms of the "living annuity" in question were indeed an "annuity" for income tax purposes, and were therefore taxable as such in his hands.

At first instance, the Cape Tax Court had held in ITC 1797 (2005) 67 SATC 377 that the amounts, paid under the living annuity in issue, were not an "annuity" for income tax purposes, and that what was repaid to the taxpayer, month by month, were part-repayments of the initial capital investment plus interest. This finding was upheld on appeal by the Cape High Court.

It follows that only the interest component of the monthly return on the investment, derived by an investor in this particular arrangement, is subject to income tax, bearing in mind that receipts and accruals of interest up to a specified annual amount are exempt from tax; see section 10(1)(xv)(bb) of the Income Tax Act 58 of 1962 (hereinafter "the Act").

2 The nature of an annuity

The major interest of the decision in the present case is the light which it throws on the nature of an annuity, for tax purposes, and in particular on the

meaning of the oft-cited principle that, for an amount to constitute an annuity, the capital must have "gone" or "ceased to exist".

In *Foley v Fletcher* ((1858) 28 LJ Ex 100; 157 ER 678) Baron Watson said that –

> "an annuity means where an income is purchased with a sum of money, and the capital has gone and has ceased to exist, the principal having been converted into an annuity".

In *ANZ Savings Bank Limited v FCT* (25 ATR 369), a judgment of the Federal Court of Australia, Hill J (372) noted that this passage had "been cited with approval in virtually every case decided after *Foley v Fletcher*, although without close analysis of what is meant by the words, 'the capital has gone and ceased to exist'".

In *Deary v Deputy Commissioner of Inland Revenue* (121 LT 121) the nature of an annuity was explained as follows –

> "A man may sell his property for a sum which is to be paid in instalments and when you see that that is the case, that is not income nor any part of it. A man may sell his property for what is an annuity – that is to say, he causes the principal to disappear and an annuity to take its place."

In *KBI v Hogan* (1993 4 SA 150 (A) 159C-F) it was held that –

> "Annuities differ from other investments in that the capital sum invested is not returnable when the annuity ceases to be payable."

In the *ANZ Savings Bank* (*supra*) decision, Davis J explained the distinction between a loan and an annuity thus:

> "when monies are lent, there is an obligation on the part of the borrower to repay the loan. If an annuity is purchased, there is no obligation on the part of the annuity provider to repay the price paid. The obligation is to pay the agreed annuity and no relationship of debtor and creditor exists with respect to the price paid".

In deciding whether a particular amount received by a person is or is not an annuity, it is necessary to examine the terms of the particular contract in terms of which that person derived the amount in question. Of particular significance is the question whether the capital sum in question has "disappeared" or "ceased to exist", but a further problem is to determine precisely what these words mean.

The background to the case under scrutiny in this note was that the taxpayer in question had transferred approximately R6-million from his pension fund to Momentum Life Administration Services (hereinafter "Momentum").

The contract between the taxpayer and Momentum provided that the taxpayer could instruct Momentum to pay him monthly amounts equal to not less than 5% and not more than 20% annually of the total value of that R6-million investment. The contract provided further that Momentum undertook to act as the taxpayer's agent in investing the capital in the money market or in specific unit trusts; that the taxpayer could instruct Momentum to vary the

investment of the capital and accepted full liability for the investment risk associated with those instructions.

The Tax court held (SATC 382F) that –

> "although the appellant agreed to tie up his capital in order to obtain payment from his Pension Fund, in effect the agreement provided for the return of all his capital plus the income therefrom until the capital was exhausted. Accordingly, it is not an annuity".

SARS argued that the taxpayer was not the "true owner" of the investment because he could not withdraw it at will. Giving judgment in the Tax Court, Traverso J said that she was not sure what was meant by the term "true owner" and the mere fact that the taxpayer could not draw the money was not decisive. There were many investments, said the judge (SATC 381H), which were not annuities, where the investor could access the funds only after a certain period or under specified circumstances.

In parenthesis, it needs to be pointed out that the minute of the pre-trial agreement entered into between the parties recorded that Momentum "had no proprietary or financial interest in the capital sum" and that the unit trusts in which some of the capital was invested "never belong" to Momentum.

It is submitted, the pre-trial agreement was certainly wrong, in law, on the first point and probably wrong on the second. As to the first point, the funds held by Momentum belonged to it since ownership in money passes by *commixtio*. As to the second, it seems highly doubtful that the unit trusts were acquired and held in the name of the taxpayer, rather than in the name of Momentum. The taxpayer was presumably one of many individuals who contracted with Momentum for this particular living annuity and the overwhelming probability is that the unit trusts were acquired in the name of Momentum and held by it in a generic pool for the credit of that group of investors.

The Tax Court ignored the provisions of the pre-trial agreement in this regard and did not find it necessary to define, in its judgment, the nature of the taxpayer's interest in the capital fund held by Momentum. The unarticulated premiss of the judgment is that, in order to hold that the amounts derived by the taxpayer from his investment were not an annuity, it sufficed to establish that a capital fund existed (irrespective of the legal nature of the taxpayer's interest in that fund) and that the payments to the taxpayer came out of that fund and would terminate when that fund was exhausted.

On appeal to the Cape High Court, SARS argued (SATC 285H) that the taxpayer did not own the underlying assets comprising the capital fund and that Momentum was not his agent.

The court held that Momentum "was not a beneficial owner" of the capital fund that it had received from the taxpayer's erstwhile pension fund, and went on to say (SATC 285I) that –

> "the R6 million which [Momentum] received was money it received on behalf of respondent. In my view, it also received that money for the benefit of

> respondent. … In my view the money which Momentum received on behalf of respondent was money which it was obliged to invest for the benefit of respondent in order to carry out its contractual obligation to make periodical payments to respondent. … It seems to me that the 'disappearance of capital' test is particularly misleading in a situation such as the present. … [M]oney is a fungible and the actual money obviously disappears when investments are bought with that money. Throughout his life, the respondent will be in control of the investment of his capital or the capital which was paid by [the pension fund] to Momentum for his benefit, whichever way one wishes to describe it. Respondent is entitled to regulate within agreed limits how much of this fund is to be paid to him annually. In a very real sense, therefore, the capital paid to Momentum on respondent's behalf and for his benefit cannot be said to have 'disappeared'. It had to be held by Momentum to cover Momentum's obligation to respondent until that obligation was entirely fulfilled".

The High Court therefore stopped short of holding that Momentum held the capital fund in trust, *stricto sensu*, for the taxpayer. Nor did the court explicitly find that Momentum held that fund as the taxpayer's agent.

The unsatisfactory feature of the judgments of the Tax Court and the High Court is, with respect, the way in which, inter alia in the passage just quoted, phrases such as "on behalf of" and "for the benefit of" and "in control of" are used loosely and colloquially, without regard for their established legal connotation. The *dicta* in the High Court judgment that the capital fund, held by Momentum, was the "guarantee" (see 286B) held "to cover" (see 286C) Momentum's obligations toward the taxpayer seem also to have been intended in a colloquial sense.

The phrase "on behalf of" usually connotes an agency relationship. "For the benefit of" is ambiguous, but suggests a trustee-type relationship; "in control of" is also ambiguous – it could mean the direct control that an owner exercises over his property, or it could mean indirect control in the sense of a contractual power to give instructions as to how property, held by another party, is to be dealt with.

The High Court held (285I) that "Momentum was not a beneficial owner" of the funds in question, but said that these were funds which it "received on behalf of" the taxpayer and that Momentum also received these funds "for the benefit" of the taxpayer.

3 The proper articulation of the legal relationship

In my view, the correct way of defining, in legal terms, the relationship between the taxpayer, Momentum, and the fund in question lies in the observation by the High Court, as quoted above, that –

> "the money which Momentum received on behalf of respondent was money which it was obliged to invest for the benefit of respondent in order to carry out its contractual obligation to make periodical payments to respondent" –

save that the phrases "on behalf of respondent" and "for the benefit of respondent" should be excised from this dictum, since these words erroneously imply that Momentum held the funds or the investment as agent

or trustee for the taxpayer. Shorn of these phrases, the *dictum* correctly expresses the straightforward contractual obligation.

The crucial aspect of the facts of this case, it is submitted, is that the moneys transferred to Momentum from the taxpayer's pension fund and placed by Momentum in the money market or used to purchase unit trusts, constituted an identifiable monetary fund and an identifiable number of units in particular unit trusts acquired by Momentum with funds provided by the taxpayer. (By "identifiable", I mean identifiable in Momentum's accounting records.) Even though Momentum was, in law, the owner of those funds and those units, the taxpayer did not merely have a right to periodical payments out of those funds; he had a contractual right to make withdrawals from that fund, subject to the agreed annual restrictions, until the fund was exhausted.

The fact that the taxpayer had not exchanged his capital for a right to periodical payments (as occurred in *KBI v Hogan supra*) meant that the amounts withdrawn by him did not constitute an "annuity", but part-repayments of capital.

The significance of the judgment of the Tax Court and of the High Court is the implicit finding that, for a periodical payment to fall outside the scope of an "annuity", it is not necessary that the taxpayer "own" the capital fund out of which the payments are made, nor that the capital fund be held "on his behalf" in the agency sense of the word or "for his benefit" in the sense of being held in trust. It is submitted that it is implicit in the judgments that, so long as a capital fund exists, in other words, so long as the capital fund has not "disappeared" or "ceased to exist", and so long as the payments to the taxpayer come out of that fund and will cease when the fund is exhausted, the periodical payments to the taxpayer will be part-repayments of capital, and not an annuity.

It is submitted that it is in this expanded sense that earlier case law must be interpreted where it suggests that where a taxpayer has a right to periodical payments, those payments constitute an annuity if his capital has "disappeared" or "ceased to exist".

It must be emphasized, however, that in any given situation, the question whether an amount received by a payee is an "annuity" will turn on an interpretation of the provisions of the particular contract in terms of which the payments are made. The mere fact that the contract calls the payments an "annuity" – as occurred in *CSARS v Higgo* (*supra*) – is neither here nor there, and it is also irrelevant that the contract uses language which erroneously suggests that the payer is holding and managing money and assets in question as the taxpayer's agent where the contract, as a whole, reveals that this does not reflect the proper legal interpretation of the factual scenario.

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