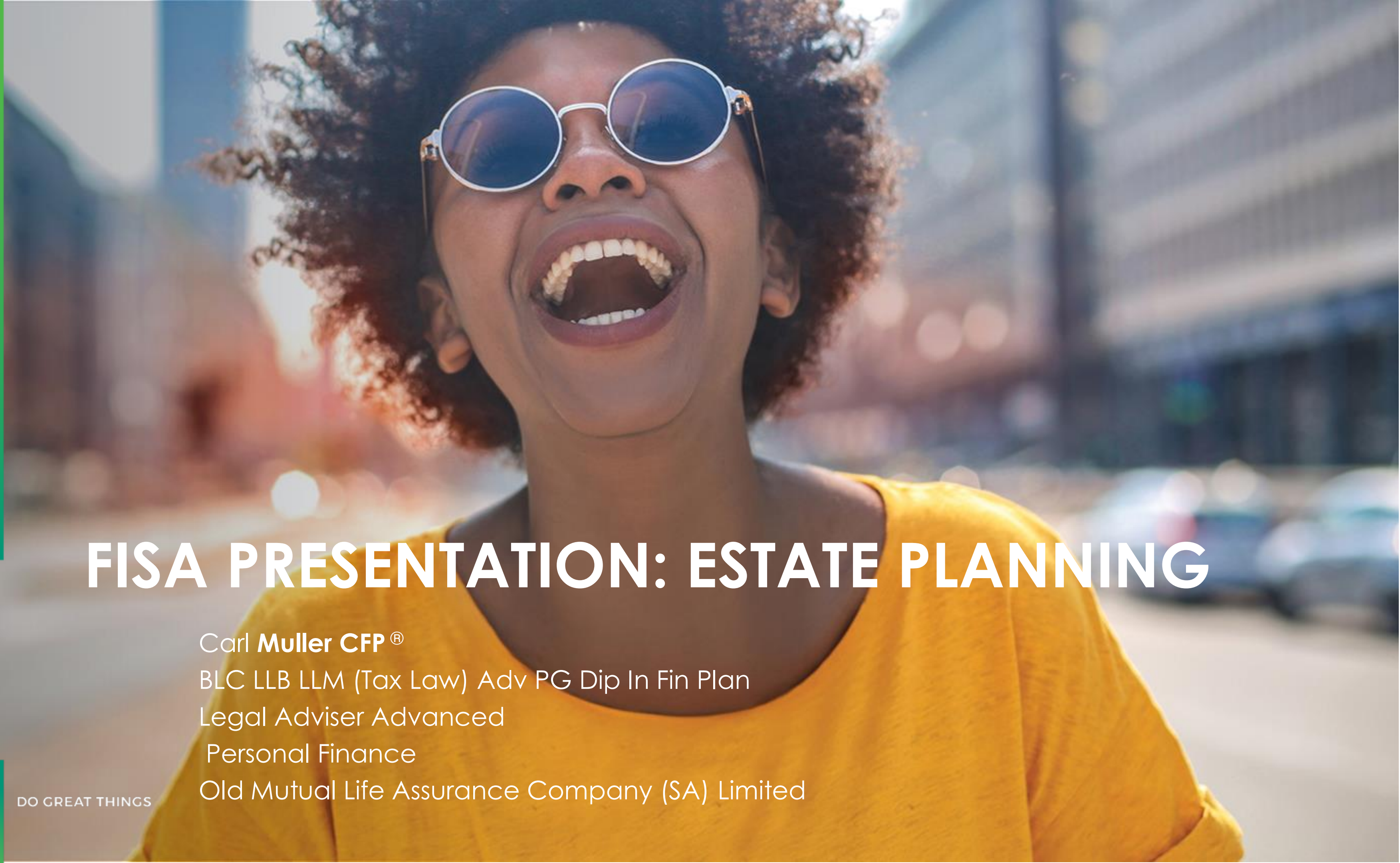

OLDMUTUAL

FISA PRESENTATION: ESTATE PLANNING

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DO GREAT THINGS

Agenda

- **FISA Agenda- Session 1:**
  - ✓ Essential elements of an estate plan
  - ✓ Estate duty implications of disallowed contributions to retirement funds
  - ✓ Living Annuities and Estate Planning
  - ✓ Estate Planning: Critical Illness Benefits on Life Insurance Policies

ESTATE PLAN: ESSENTIAL ELEMENTS

- Aspects to be included in Estate Plan:

(i) Liquidity analysis: estate duty, capital gains tax, income tax, debt/claims against the estate, executor fees, transfer costs of fixed property, Master's fees, final expenses (funeral etc.), other costs in winding up estate, cash bequests, possible provision for accrual claim of spouse

(ii) Provisions for dependants/Maintenance: surviving spouse, children, maintenance orders: what is the need vs what is in place; when dealing with retirement funds, remember to take the possible effect of Sec 37C of the Pension Funds Act into consideration;

(iii) Comments on existing will: provisions in current will (e.g. bequest of farm property to more than one person in contravention of Subdivision of Agricultural Land Act), possible ways of amending will to still meet wishes of client but bringing about savings in estate duty, capital gains tax etc.;

(iv) Negotiating decreased executor fees (especially in bigger estates);

(v) Discussion on trusts: benefits (e.g. saving estate duty, capital gains tax, executor fees, protection against creditors, marriage regimes of beneficiaries) and pitfalls (donations tax/transfer duty/capital gains tax payable on transfer, the effect of Sec 7C of the Income Tax Act), comments on existing trust deeds)are the beneficiaries correct, too much control by founder, independent trustees; sufficient number of trustees in terms of trust deed etc.);

(vi) Provision for disability/critical illnesses

(vii) Business planning: business debt cover, succession planning (e.g. buy and sell agreements funded by life insurance: ensure agreement is in place); provision where client signed surety on behalf of business (e.g. contingent liability insurance: ensure that agreement is in place); is client or someone else a key person in relation to the business (possible key person cover in this regard. NB to understand and explain the income tax and estate duty implication where business assurance need is identified.

(viii) Summary of recommendations based on analysis.

ESTATE DUTY IMPLICATIONS OF DISALLOWED CONTRIBUTIONS TO RETIREMENT FUNDS

- Maximum retirement age of 70 in respect of membership to retirement annuity funds was removed in 2008.
- From 1 January 2009, no estate duty payable in respect of lump sums received from pension, provident, preservation or retirement annuity funds, and annuities received from these funds were already exempt from estate duty before this.
- As a consequence of these amendments, retirement funds became an attractive estate planning tool. National Treasury however viewed some of the transactions that were entered into as avoidance through excessive contributions to, in particular, retirement annuity funds.

ESTATE DUTY IMPLICATIONS OF DISALLOWED CONTRIBUTIONS TO RETIREMENT FUNDS

- *Example: before amendment of Estate Duty Act*
- *Mr A is diagnosed with a terminal illness and his medical practitioner estimates his reasonable life expectancy to be 6 months at most. Mr A invests R10 000 000 in a retirement annuity fund on 1 October 2014 and dies 3 months later. His non-retirement funding income for the year of assessment up to his date of death was R1 000 000. Mr A had never, prior to his death, received any lump sum from a retirement fund on withdrawal or retirement, nor had he been the recipient of severance benefit from an employer. At the time of his death the investment was worth R10 200 000. His dependants/beneficiaries opt to take the full benefit as a lump sum.*
- *The effect of this is that the full amount of R10 200 000 is not subject to estate duty. From a tax point of view, the situation will look as follows:*

  R1 000 000 (non-retirement funding income) x 15% = R150 000.
- *His taxable income for the year of assessment (for normal income tax purposes) is thus:*

  R1 000 00 – R150 000 = R850 000.
- *When the beneficiaries opt to take the lump sum the lump sum is deemed to have accrued to Mr A immediately prior to death, and it will thus be taxable in his hands.*
- *Therefore:*

  R10 200 000 – R9 850 000 (R10 000 000 contributions minus R150 000 deduction allowed in terms of section 11(k))

  = R350 000 (taxable portion of the lump sum).
- *As Mr A had not previously received any qualifying lump sums from retirement funds or severance benefits from an employer, the amount of R350 000 will be taxed as follows:*

  R350 000 taxed at 0%

  = R0.
- *If the amount had been invested by Mr A in an investment other than a retirement fund at the same growth rate, this investment would, assuming that the R3 500 000 estate duty abatement is used in respect of other property or deemed property in his estate, have attracted additional estate duty in the amount of R2 040 000 (R10 200 000 x 20%) – the effect of possible capital gains tax is however ignored in this example.*

ESTATE DUTY IMPLICATIONS OF DISALLOWED CONTRIBUTIONS TO RETIREMENT FUNDS

- The effect of the tax and estate duty benefits through tax avoidance schemes as discussed above was the amendment of the Estate Duty Act by the promulgation of Section 3(2)(bA), which provides as follows:
- *(2) "Property" means any right in or to property, movable or immovable, corporeal or incorporeal, and includes—*

  (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;
- The purposes of the above section is thus to include contributions made to retirement funds not allowed as a deduction or exemption as at date of death, as property in the estate of the deceased person who made such contributions, thus potentially increasing the liability for estate duty in this regard.
- It is however important to note that Section 3(2)(bA) is only applicable in respect of:

  i. The estate of a person who dies on or after 1 January 2016; and
  ii. Contributions made to pension, provident or retirement annuity funds on or after 1 March 2015 that were not allowed as a deduction under section 11(k), or the Second Schedule of the Income Tax Act or exempted against compulsory annuity income in terms of Section 10C of the Income Tax Act.

ESTATE DUTY IMPLICATIONS OF DISALLOWED CONTRIBUTIONS TO RETIREMENT FUNDS

- Section 4q of the Estate Duty Act allows for a deduction from the value of property included in the estate, so much of the value of such property accruing to the surviving spouse of the deceased that have not been allowed as a deduction elsewhere. Section 4q provides as follows:

  4. Net value of an estate.—

  The net value of any estate shall be determined by making the following deductions from the total value of all property included therein in accordance with section 3, that is to say—

  *(q) **so much of the value of any property included in the estate** which has not been allowed as a deduction under the foregoing provisions of this section, **as accrues to the surviving spouse of the deceased**:*

- Generally speaking, the provisions of Section 4q are clear – any property in the estate accruing to the spouse of the deceased will be deductible from the gross value of the estate. Section 3(2)(bA) is however unique in the sense that it is merely the contributions to a pension, provident or retirement fund not allowed as a deduction or an exemption, as discussed above, that is included as property in the estate of the deceased, and not the fund value of the investments in these funds (prior to retirement) or the investment in a compulsory annuity (post retirement).
- The question is thus if the investment in a pension, provident or retirement annuity fund, or the investment in a living annuity accrues to the surviving spouse of the member of the fund or the holder of the annuity on death, would the section 4 q deduction be applicable. Technically speaking, one might argue that:
  i. it is the fund value (in case of a member of a fund that dies before retirement) or the investment value of a living annuity (in case of a holder of a living annuity that dies after retirement) that accrues to the spouse and <u>not</u> the contributions that were not deducted or exempted prior to death , and
  ii. because we are thus dealing with different concepts, the Section 4q deduction should not be allowed,

  even if the fund or annuity proceeds are awarded to the surviving spouse. The argument in this regard is thus that because the investment in the fund or annuity awarded to the spouse is not property included in the estate, no deduction should be allowed in respect of the contributions made by the deceased that were not deducted or exempted for income tax purposes prior to death.

ESTATE DUTY IMPLICATIONS OF DISALLOWED CONTRIBUTIONS TO RETIREMENT FUNDS

- *Example 2:*
- *Mr X makes a contribution to a retirement annuity fund in the amount of R10 000 000 on 1 March 2018 and dies on the same day. For purposes of this example it is assumed that no portion of this contribution is deductible or exempt prior to his death. The full fund benefit is awarded to his spouse. If the R3 500 000 abatement awarded in terms of section 4A of the Estate Duty Act is used elsewhere, this contribution not allowed as a deduction or exemption will attract additional estate duty of R2 000 000 (R10 000 000 x 20%).*
- *His spouse elects to take the full fund value (assume that it is still R10 000 000) as a cash amount. She invests it in a money market account and dies 11 years later, and the value in the money market account is still R10 000 000. If the R3 500 000 abatement awarded in terms of section 4A of the Estate Duty Act is already utilised (i.e. if there is other property or deemed property in her estate exceeding R3 500 000 after deductions are applied), this money market investment will again attract additional estate duty of R2 000 000 (R10 000 000 x 20%).*
- *The total estate duty payable in respect of this investment will thus be R4 000 000 (R2 000 000 in the estate of Mr X and R2 000 000 in the estate of his spouse).*
- *If Mr X had invested the funds in a money market account and bequeathed this investment to his spouse, his estate would have been entitled to the section 4q deduction, and this investment would not in effect have attracted any estate duty on his death. On the death of his spouse, and assuming that the money market investment is still R10 000 000 on her death, the estate duty payable would be R2 000 000 (R10 000 000 x 20%) if the R3 500 000 abatement awarded in terms of section 4A of the Estate Duty Act is already utilised (i.e. if there is other property or deemed property in her estate exceeding R3 500 000 after deductions are applied).*
- *The total estate duty payable in respect of this investment will thus be R2 000 000 (R0 in the estate of Mr X and R2 000 000 in the estate of his spouse).*

ESTATE DUTY IMPLICATIONS OF DISALLOWED CONTRIBUTIONS TO RETIREMENT FUNDS

- A counter argument to this could perhaps be that the contributions made by the deceased that were not deducted or exempted for income tax purposes prior to death in actual fact form part of the investment in the fund or annuity, and that it will be equitable to allow for a deduction under section 4q equal to the value of the non-deductible and non-exempt contributions.

ESTATE DUTY IMPLICATIONS OF DISALLOWED CONTRIBUTIONS TO RETIREMENT FUNDS

- Section 11 read with Section 13 of the Estate Duty Act essentially gives the executor the right to claim estate duty brought about by certain property and deemed property in the estate of the deceased from the person who enjoys the benefit for such property or deemed property. An example of this is where a person is the beneficiary, or the policyholder of a policy on the life of the deceased and the policy proceeds contribute to the liability for estate duty, the executor would be able to recover the proportionate estate duty brought about by such policy proceeds from the beneficiary or policyholder.
- Section 11 and section 13 do however not make provision for the recovery by the executor of proportionate estate duty incurred by property as defined in section 3(2)(bA). A consequence of this would be that the estate is liable for the estate duty brought about by contributions to pension, provident and retirement annuity funds not allowed as a deduction on the death of the member (or former member). This could be problematic, especially where the heirs of the estate and the beneficiaries or dependants entitled to retirement benefits are not the same persons. The end result could be that the estate, and by implication the heirs, are liable for the estate duty incurred by the contributions not allowed as a deduction or exemption on death, whilst the beneficiaries or dependants essentially reap the benefits of the retirement investment.

ESTATE DUTY IMPLICATIONS OF DISALLOWED CONTRIBUTIONS TO RETIREMENT FUNDS

- *Example:*
- *Mr X makes a contribution to a retirement annuity fund in the amount of R10 000 000 on 1 March 2018 and dies on the same day. For purposes of this example it is assumed that no portion of this contribution is deductible or exempt prior to his death. The full fund benefit is awarded to his children.*
- *The net value of his estate (inclusive of the amount of R10 000 000 in respect of the contribution to the retirement annuity fund not allowed as a deduction or exemption), before the section 4A abatement is applied is R33 500 000. The sole heir of his estate (i.e. excluding the benefit in the retirement annuity fund) is his brother.*
- *The estate duty liability will thus be:*

  R33 500 000 – R3 500 000 (section 4A abatement)

  = R30 000 000 x 20% = R6 000 000.
- *In this instance the estate will be liable for the estate duty, and will not have any recourse against the beneficiaries. It will thus have an effect on the eventual inheritance of the brother as the full R6 000 000 estate duty will be payable from the estate.*
- *If the facts had been the same as above, except for the R10 000 000 benefit being a life insurance policy on the life of Mr X of which the children had been the beneficiaries, the executor would be able to recover the proportionate estate duty from the beneficiaries of the policy as follows:*

  R10 000 000 (policy proceeds) ÷ R33 500 000 (net value of the estate) x R6 000 000 (estate duty payable)

  = R1 791 044.78
- *The balance of R4 208 955.22 (R6 000 000 – R1 791 044.78) would then be paid from property or deemed property in the estate (or by the heir of the estate, Mr X's brother).*

ESTATE DUTY IMPLICATIONS OF DISALLOWED CONTRIBUTIONS TO RETIREMENT FUNDS

- It is understandable that the Estate Duty Act was amended to prevent estate duty avoidance through the use of pension, provident and especially retirement annuity as estate planning vehicles.
- It is however submitted that the amended legislation does not take cognisance of related aspects contained in the Estate Duty Act and that it should be adjusted accordingly to make provision for:
  1. The application of section 4(q) of the said Act in order to put property as defined in section 3(2)(bA) on an equal footing with other property or deemed property defined in this Act, where there is an accrual of retirement benefits to a surviving spouse, either via a pension, provident, preservation or retirement annuity fund, or via post retirement annuities. The same principles should apply where there is an accrual of these benefits to organisations as contemplated in section 4(h) of this Act.
  2. The right of the executor to recover estate duty proportionate to the benefit received by dependants or beneficiaries in relation to the contribution of the property contemplated in section 3(2)(bA) to the total estate duty liability.

Living Annuities and Estate Planning: Beneficiary Nominations - General

- Paragraph (e) of the definition of living annuity in Sec 1 of the Income Tax Act provides:

  "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****;*

- Therefor, if there is no beneficiary (nominee) nominated, lump sum payable to estate with tax on lump sum and executor fees payable (no estate duty payable on living annuity).

Living Annuities and Estate Planning: Beneficiary Nominations - General

- Question: What constitutes a "nominee", i.e.
  i. Is it only applicable where a person is nominated on a living annuity beneficiary form; or
  ii. Would it also be applicable where a person is "nominated" as beneficiary in a will (i.e. no person nominated on living annuity beneficiary form).
- SARS gave a **non-binding opinion**: SARS follows a "restrictive interpretation" of the term nominee, and their view is that a nominee only constitutes someone nominated on a beneficiary nomination form (i.e. in line with i. above) and not a person nominated in a will. Therefore if an annuitant does not nominate any person on the beneficiary nomination form, but in his/her will, it will not constitute nominee, and the living annuity will be commuted as a lump sum (with possible tax on lump sum payable) and paid to the estate.
- **However:** The view is then expressed that if the estate is nominated (on the beneficiary nomination form) as the beneficiary, the executor of the deceased estate becomes the **"representative nominee"** of the estate, and therefore has the choice between an annuity, or a lump sum, or a combination of an annuity and a lump sum. **NB: Living annuity product will have to allow for estate to be nominated as such.**

Living Annuities and Estate Planning: Nominating a trust as beneficiary

- SARS allows a trust to be nominated as a beneficiary on a living annuity and the trustees to have the same choice as an individual on death of the annuitant, i.e. lump sum or annuity or a combination of a lump sum and annuity.
- However important to look a what the product allows, e.g.:
  - ✓ Some products allow for a trust to be nominated as a beneficiary on a living annuity, but the living annuity will have to be commuted as a lump sum on death of annuitant.
  - ✓ Some products allow for a trust to be nominated as a beneficiary on a living annuity, and the trustees will have the choice of a lump sum or annuity or a combination of a lump sum and annuity on death of annuitant.

Living Annuities and Estate Planning: Nominating a trust as beneficiary

- Question: if a trust opts for an annuity is it taxed in the hands of the trust (i.e. at 45%) or is it taxed in the hands of the annuitant (at the marginal tax rate of such annuitant)?
- SARS confirmed that:
  i. if a trust registers as an employer (for PAYE), and
  ii. provides a tax clearance certificate to the administrator of the living annuity annually,

  the administrator may refrain from withholding any tax (i.e. which would have been at the trust rate of 45%), and in effect the beneficiaries will be taxed according to their respective marginal tax rates.
- Also bear in mind that if a trust is nominated as a beneficiary of a living annuity: living annuity may only be commuted as a lump sum upon death (unless value falls below R75 000 or R50 000 dependant on whether a lump sum was taken when member of fund retired). Where a trust is the contracting party (annuitant) it can not die. Thus not commutable if a trust beneficiary dies.

Estate Planning: Critical Illness Benefits on Life Insurance Policies

- A terminal illness benefit is a contractual arrangement between an insurance company and the contracting party, where the insurance company pays to the contacting party a lump sum equal to the life assured sum of a life insurance policy in the event that the life assured is diagnosed with a terminal illness (as defined in the life insurance contract). The terminal illness benefit will automatically end the life insurance benefit. Some insurance companies only allow a portion of the life assured sum to be paid out as lump sum for terminal illness. In circumstances where only a portion of the life assured sum can be claimed, the terminal illness benefit will accordingly reduce the life assured sum and the remainder of the life assured sum will pay out at death of the life assured.

Estate Planning: Critical Illness Benefits on Life Insurance Policies

- Where the policy contract contains a “no rights” clause, the beneficiary merely has a *spes* (an expectation) during the lifetime of the life assured. The beneficiary has no rights to the policy benefits during the lifetime of the life assured and the benefit only becomes due once the beneficiary has accepted the benefit, which in essence can only be done once the life assured dies. The acceptance of the benefit by the beneficiary therefore completes the contract and makes the beneficiary a party to the contract.
- The diagnosis of a terminal illness on a life insurance policy does therefore not trigger the insured event, being death, and the beneficiary accordingly does not have any claim to the terminal illness benefits, which is also enforced by the “no rights” clause, which is contained in most life insurance contacts. Most life insurance contracts furthermore stipulate that the terminal illness benefit will only be paid to the contracting party.
- The terminal illness benefit claim is therefore a contractual arrangement between the life insurance company and the contracting party, in that the insurance company will pay the life insurance benefit to the contracting party should the life assured be diagnosed with a terminal illness, as defined by the insurance company. The proceeds of the terminal illness benefit will therefore vest in the contracting party. The life insurance benefit will accordingly fall away once the terminal illness benefit is claimed.

Estate Planning: Critical Illness Benefits on Life Insurance Policies

- **Income Tax**
- Section 10(1)(gl) of the Income Tax Act was introduced on 1 March 2015 and reads as follows:
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- *(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;
- Section 10(1)(gl) 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.
- Therefore: No income tax on Critical Illness benefit

Estate Planning: Critical Illness Benefits on Life Insurance Policies

- **Estate Duty**
- The Estate Duty Act, deals with the taxation of an individual's estate at death. In terms of section 2 of the Estate Duty Act, estate duty shall be collected and levied on a person's (who was ordinarily a resident in the Republic of South Africa at the date of death or who was not ordinarily resident, but owned assets in the Republic of South Africa) estate who dies on or after the first day of April 1955. The duty payable is to be known as estate duty.
- Section 3(2) of the Estate Duty Act defines what assets form part of a person's estate as at date of death.
- Section 3(3) of the Estate Duty Act includes certain deemed property into the estate of the deceased person. Deemed property can be described as property which did not exist as real property at the date of death of the deceased or which did not form as asset of the deceased prior to death. A policy on the life of the deceased is defined in section 3(3)(a) as deemed property.
- A terminal illness benefit will therefore vest in the contracting party and accordingly form part of the estate if the contracting party and the life assured is one and the same person. The proceeds of the terminal illness benefit, or of what is left thereof at date of death of the contracting party, will form part of the contracting party's estate for estate duty purposes.

Estate Planning: Critical Illness Benefits on Life Insurance Policies

- **Example - contracting party and life assured is the same person**
- Mr A is the owner of a life insurance policy on his life. Mr A is diagnosed with terminal cancer and successfully institutes a terminal illness benefit claim against an insurance company. He reinvests the proceeds and passes away thereafter. The investment will therefore constitute property in Mr A's estate in term so section 3(2) of the Estate Duty Act.

Estate Planning: Critical Illness Benefits on Life Insurance Policies

- If the contracting party and the life assured are two different people, the proceeds of the terminal illness benefit will vest in the contracting party and the insurance company will accordingly pay the benefits out to the contacting party. The proceeds of the terminal illness benefit will fall outside the ambit of sections 3(2) of the Estate Duty Act, as it does not fall within the deceased's dutiable estate once the life assured passes away. It will furthermore not form part of deemed property in the deceased's estate in terms of section 3(3) of the Estate Duty Act, as there is no amount due and recoverable under any policy of insurance, which is a domestic policy, upon the life of the deceased on date of death.
- **Example - contracting party and life assured is not the same person**
- XXX (Pty) Ltd is the contracting party of a life insurance policy on Mr A's life for business contingency purposes. Mr A is diagnosed with a terminal illness and XXX (Pty) Ltd institutes a terminal illness benefit claim against the insurer for the full death benefit amount. The lump sum terminal illness benefit will not fall in the estate of Mr A, as Mr A is still alive when the benefit pays out. Even though Mr A passes away thereafter, the lump sum benefit will not form part of his estate, due to the fact that it paid out to XXX (Pty) Ltd while Mr A was still alive. At Mr A's death, the benefit will not form part of his property as it is not property owned by him as defined in section 3(2). It will furthermore not be regarded as deemed property, as defined in section 3(3), as there is no amount due and recoverable under any policy of insurance, which is a domestic policy, upon the life of the deceased on date of death.

Estate Planning: Critical Illness Benefits on Life Insurance Policies

- **Donations Tax**
- Donations Tax is a tax on the transfer of assets, which is imposed on person who may want to move assets to different entities or individual in order to avoid income tax or estate duty.
- Section 54 of the Income Tax Act provides that donations tax is payable on the value of any property disposed of under a donation by a resident of the Republic of South Africa. The provisions do not apply to non-residents, even if they donate assets within the borders of South Africa.
- Sections 55 of the Income Tax Act defines a number of words of which the following are applicable for purposes of this article.
- "Donation": *Any gratuitous disposal of property or any gratuitous waiver or renunciation of a right.*
- As discussed above, the proceeds of a terminal illness benefit will vest in the contracting party once the life assured has been diagnosed with a terminal illness, which in terms of the policy contract constitutes a terminal illness.
- Some insurance companies allow the benefit to be paid out to a third party, which could be the original beneficiary on the life insurance agreement. However, it is important to note that such a payment is an arrangement between the insurance company and the contracting party and it must not be seen as the insurance company paying out the terminal illness benefit in terms of the original life insurance policy agreement.
- The payment of the terminal illness benefit to a third party, on instruction of the contracting party to the insurance company, will lead to a gratuitous disposal property and accordingly donations tax will be payable on the proceeds of the terminal illness benefit. If not a donation, it could lead to the creation of a loan account between the contracting party and the beneficiary.

Questions