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ESTATE PLANNING TRUSTS WILLS ESTATES BENEFICIARY FUNDS

Living annuities and the accrual dispensation: *CM v EM* [2020] 3 All SA (SCA)

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Introduction

Ever since the introduction of accrual, questions have been asked about the rights of spouses to pension funds. This has resulted in amendments to the Divorce Act and the Pension Funds Act. Living annuities are regulated by the Long-Term Insurance Act. The status of a living annuity for accrual purposes and for maintenance purposes were uncertain.

Two recent matters in the Supreme Court of Appeal brought some clarity, although not all questions have necessarily been answered.

Introduction continues

What is accrual in respect of an estate: it is the amount by which the net value of the estate at the dissolution of the marriage exceeds the net value of that estate at the time of commencement of the marriage.

At the dissolution of the marriage subject to the accrual system, due to death or divorce, the spouse whose estate shows no accrual or a smaller accrual than the estate of the other spouse, has a claim against the estate of the other spouse or his or her deceased estate.

In the case of a living annuity the question is whether such an investment is subject to the accrual system.

Montanari case

The parties were married out of community of property, subject to the accrual system, and in the process of divorce. The respondent purchased three living annuities during the duration of the marriage. He argued that these annuities should be excluded as assets from his estate for the purposes of an accrual calculation. In the High Court, Victor J decided that the respondent's living annuities did not form part of his estate for the purposes of accrual, and on appeal a full bench of the High Court confirmed this decision.

Montanari continues

The respondent argued that ownership of the capital in a living annuity vests in the insurer, with the investor's only entitlement being the annuity income.

The court agreed with the respondent, but was of the opinion that the annuity income may only be taken into consideration to determine future maintenance needs.

An actuary testified that it was possible to determine the market value of the income stream generated by a living annuity, by taking into account variables such as the investment return assumptions, the level of contributions and the annuitant's mortality.



CM v EM (SCA)

In *CM v EM*, the SCA had 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. It was an application for special leave to appeal from the finding made by the High Court in the *Montanari* case regarding living annuities held by the respondent.

The parties agreed that the living annuities did not qualify as a pensionable interest as defined in the Divorce Act. The question was however, whether living annuities formed part of the estate of the annuitant.



CM v EM continues

Factors that the court considered:

The annuitant had the right to decide about the underlying investments, to nominate beneficiaries, and to determine the level of income and the frequency of payment. The relationship between the annuitant and the insurer was purely **contractual** in nature. The **right to the annuity**, and not the capital, was an asset in the estate of the annuitant. Besides that, it was an asset which could be valued.

The High Court considered the annuity income as being relevant only for **maintenance purposes**, while the SCA found it to be an asset for **accrual purposes**.

ST v CT (SCA)

This case was decided shortly before *CM v EM*, but after the High Court decision in *Montanari*. The court decided that the capital value of a living annuity belongs to the insurance company and the annuitant has a **conditional contractual right** to be paid an annuity by the insurer. *The court decided that a living annuity does not form part of the annuitants estate for purposes of calculating accrual.*

The court refrained from determining whether the right of the annuitant to future payments was an asset in his estate. The court did, however, remark obiter, that the value of the annuitant's right could **not** be equated to the value of the capital.

What about life annuities?

The court differentiated between living annuities and life annuities, but implied that all life annuities are fund-owned, while life annuities can in fact also be member-owned. It seems as if the court implied that the principles laid down in this case for living annuities are not necessarily applicable to life annuities.

We submit that living annuities and life annuities should be treated the same as the principle laid down is not about ownership of the annuity, but the right of the annuitant. It is not about the origin of the right, but whether a right to income has vested, which can be regarded as an asset in the annuitant's estate.

What is the legal position?

1. The capital in a living annuity belongs to the insurer
2. A living annuity does not form part of the annuitants estate
3. Living annuities do not fall within the ambit of 'pension interest' in the Divorce Act
4. The annuitant has a contractual right in a future income stream
5. A living annuity consists of two distinguishable monetary parts: the capital value and the income stream
6. The value of the capital does not equate to the value of the income stream
7. The right in the income stream is both identifiable and quantifiable
8. The right to an income stream from a living annuity can be considered both as part of a accrual claim or a maintenance claim
9. These principles are extendable to deceased estates
10. It should follow that the same principles also apply to life annuities if the annuitant has a contractual right to income



What does this mean?

Estate planners and executors will have to determine the value of the right to an income from living annuities where parties are married in community of property or with accrual.

In *ST v CT* the court stated 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 draw-downs from the annuity.

In *ST v CT* the court further stated that although it was not possible to establish an exact value of the right to income, it had to "attempt a realistic and reasonable quantification".

The SCA refrained from giving practitioners a particular formula to use as it referred the matter back to the High Court.



The value of the income stream in case of a deceased estate

No objectively correct value is possible, due to the many subjective factors.

An objective starting point will be the value of the income stream at the level of drawdown effective at the time of death.

The following can be used as guide:

- the drawdown percentage at time of death, e.g. 5%
- CPI inflation, e.g. 4.5%
- the 10-year government rate as the discount rate, e.g. 9.5%
- the annuitant's life-expectancy on the day before his or her demise, as per the latest actuarial tables



Example

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

Deceased is a male person, 70 years of age. His life expectancy the day before his death was 9.37 years. The capital value of the live annuity is R5m. The withdrawal rate at death is 5%. CPI is 4.5% and the R186 bond rate is 9.5%.

$$R250\,000 \times \frac{1 - (1.045)^{9.37}}{(1.095) - 1} = \frac{0.35}{0.05}$$

$$R250\,000 \times 7 = R1\,750\,000$$

Value of income stream to be taken into account for accrual purposes: R1.75m

Conclusion

This decision is important for a number of reasons:

- due to the strict principle of freedom of testation in our legal system, it must be exercised within a framework of fairness;
- the two legs of protection for the spouse with the lesser opportunity to grow his or her estate, are the election of an appropriate marital regime and the right to maintenance;
- the exclusion of living annuities and life annuities from protection in terms of pension and divorce legislation may have led to serious prejudice;
- the inclusion of living annuities and life annuities within the parameters of maintenance and accrual will definitely bring more balance between spouses in a society still riddled with economic unfairness based on gender;

Conclusion continues

- this development may allow freedom of testation to survive future attacks;
- estate planning advisors must consider the potential impact of this development in the estates of parties married in community of property or with accrual;
- executors will have to determine the value of the future income stream in all such cases;
- the legal and fiduciary industry will have to develop acceptable formulas of calculation as it is unlikely that the courts will give clear answers in the near future



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Thank you