DAVEY'S Locker

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Living annuities

Tax relief upon post-retirement commutation

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Nature of a living annuity

Upon retirement from a retirement fund (pension or retirement annuity), a compulsory life annuity, being either a conventional annuity or a living annuity, must be purchased with at least two-thirds of the member's fund value. An exception allowing for a full commutation arises when the member's total fund value does not exceed R75 000.

Living annuities, as distinct from conventional annuities, have become increasingly popular in an inflationary environment as a means of preserving or even increasing the value of retirement benefits, since the underlying investment portfolio comprises asset classes such as equities, property and bonds. Naturally, the usual risk-and-return investment principles apply.

In 2008 statutory recognition of such annuities was granted by the insertion of a definition of a 'living annuity' in s 1 of the Income Tax Act.

Proposed tax treatment

It is trite tax law that an annuity is inherently subject to tax, in that the definition of the term 'gross income' in s 1 includes, under paragraph (*a*)

> any amount received or accrued by way of annuity, including any amount contemplated in the definition of '**living annuity'**….

The specific inclusion of a reference to a 'living annuity' in the definition, sparked by a controversial tax court decision, puts beyond all doubt the fact that a living annuity contains no capital element for tax purposes and is inherently fully subject to tax. It follows that, upon commutation of a living annuity, which is allowed if its value falls below R75 000 or upon the death of the annuitant, the commuted lump sum is included in gross income and subjected to tax.

Nevertheless, in an act of benevolence, the 2010 Taxation Laws Amendment Bill proposes that such commutations should qualify for the special concessionary retirement table (albeit upon an aggregated basis)—the R300 000 tax exemption and the sliding-scale rates—and is to be effective as from 1 March 2011.

This outcome is achieved by proposed amendments to the definition of a 'lump sum benefit' in para 1 of the Second Schedule to the act, and to paras 2, 3 and 3A of the schedule.

It is important to note the application of the aggregation principle. In essence, if the commutation occurs during the member's lifetime (value below R75 000 threshold) or upon the member's death, aggregation occurs for the member. If the commutation occurs during the successor annuitant's life or upon the successor's death, aggregation occurs for the successor.

For example, if upon the death of the first annuitant, the original member of the retirement fund, the second annuitant commutes the living annuity, the tax-free portion available is R300 000 less any portion already used by the first annuitant, for example, upon retirement. Thereafter the special-rate tables apply. Upon death of the second annuitant (assuming there was no commutation), the third annuitant may benefit from any tax-free portion unused by the second annuitant.

The tax is always recoverable from the actual recipient of the commuted lump sum.