

**REPORTABLE**

**CAPE INCOME TAX SPECIAL COURT**

**BEFORE :**

**The Honourable Justice JHM Traverso : President**  
**Mr. I.Z. Willis : Accountant Member**  
**Mr. B.B. Justus : Commercial Member**

**CASE OF**

**NO: 11135**

**(Heard in Cape Town on 17 August 2005)**

**J U D G M E N T**

**[1]** The facts involved in this case are common cause.

**[2]** They are formulated as follows in the minutes of a pre-trial conference held between the parties:

***“1. Prior to 1 September 1998 the Appellant was a pensioner of the A Pension Fund. When the nature of this fund was changed from a “defined benefit (sic) fund” to a “defined contribution fund” pensioners of the fund were given the choice of remaining with the fund and having their pension enhanced by a percentage (such percentage arising from an actuarial surplus) or of leaving the***

*fund subject to investing the amount payable, namely the actuarial valuation of their previous benefits plus a percentage arising from the surplus, in what was termed a retirement income option.*

2. *The Appellant chose the latter and on 26 August 1998 entered into an agreement with B (hereinafter referred to as "B")*
  
3. *On 26 August 1998 the Appellant entered into an agreement with B in terms of which he would invest an amount just in excess of R6 million in a "life annuity" with B with effect from 1 September 1998, which would give him an initial guaranteed income of R41, 666,66 per month, the first instalment which was payable on 30 September 1998. This could be revised annually at the instance of the Appellant subject to Appellant being limited at the time of revision to direct B to pay him monthly amounts equal to not less than 5% and not more than 20% annually of the total value of the Appellant's investment on the anniversary of 1 September. Appellant revised the monthly sum to R50 000,00.*

...

5. *The two parties further agreed as follows:*
  - (a) *The appellant was entitled to instruct B to vary the investments for which purpose he was to employ a financial adviser and had to declare *inter alia*, that:*
    - (i) *he accepted full liability for the investment risk associated with his instructions to B and acknowledge that in making his investment decisions no reliance has been placed on any financial advice that may have been given by B;*

- (ii) *he authorized B to act as his agent in placing the investments in the money market and/or specific unit trusts according to his instructions.*
- (b) *The Appellant was responsible:*

  - (i) *for paying B an “up-front” investment fee as well as an annual investment fee equal to 0.05% per annum (excluding VAT) of the value of the investment;*
  - (ii) *for paying the fees of his financial adviser.*
- (c) *The Appellant was not allowed to make any withdrawals from his investment save for the amounts mentioned in paragraph 3 supra.*
- (d) *The Appellant was not allowed to terminate his investment in the retirement investment option unless he transferred this investment to another registered insurer.*
- (e) *On the death of the Appellant an annuity would become payable to his dependants and/or beneficiaries indicated in his contract with B until the total amount invested was exhausted.*
- (f) *The monthly income which the Appellant would receive would be taxable and B would deduct PAYE therefrom. The growth in the Appellant’s investment would be non-taxable.”*

**[3]** The appellant was taxed on the basis that the amount paid to him by B in terms of the contract was an annuity and thus gross income in terms of paragraph (a) of the definition of gross income in section 1 of the Income Tax Act, No. 58 of 1962. Section 1(a) provides:

**“‘gross income’, in relation to any year or period of assessment, means –**

- (i) in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or**
- (ii) in the case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within or deemed to be within the Republic, during such year or period of assessment, excluding receipts or accruals of a capital nature, but including, without in any way limiting the scope of this definition, such amounts (whether of a capital nature or not) so received or accrued as are described hereunder, namely – 6.1, 6.39, 7.3**
  - (a) any amount received or accrued by way of annuity, including any amount contemplated in the definition of ‘annuity amount’ in section 10A (1).”**

**[4]** It is the appellant’s case that he should have been taxed on the basis that the income generated on the capital amount invested by him constituted gross income under the general portion of the definition of gross income, and not in terms of section 1(a).

**[5]** The distinction between the payment of a capital debt in instalments and an annuity is not easy to draw. Generally – if what is being repaid is a debt, it is not an annuity whereas if the periodical payment is not in respect of a debt owing or in liquidation of a debt it is an annuity (See Meyerowitz on Income Tax, 2004-2005, 9.8 – 9.10)

[6] “Annuity” is not defined in the Act. The Courts have however dealt with this question on several occasions.

[7] In Deary v. Deputy Commissioner of Inland Revenue, 121 L.T. 121, it is defined 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. If you can see that that is what it is then the Income Tax Act taxes it. Or a man may sell his property for what looks like the annuity, but you can see quite well from the transaction that it is not really the transmutation of a principal sum into an annuity, but it is a principal sum of payment of which is being spread over a time and is being paid with interest, and it is all being calculated in a way familiar to accountants and actuaries although taking the form only of an annuity ... when you break up the sum and decide what it really was.” (Underlining supplied)*

[8] This *dictum* was adopted by the Appellate Division (as it then was) in Kommissaris van Binnelandse Inkomste & ‘n Ander v. Hogan, 1993(4) SA 150 (AD) at 159 C-F. See also Commissioner for Inland Revenue v. Milstein, 1942 (TPD) 57 at 64:

*“Par. (a) includes under gross income “any amount so received or accrued by way of an annuity.” Annuities differ from other investments in that the capital sum invested is not returnable when the annuity ceases to be payable. Baron WATSON’S description of an annuity in Foley v. Fletcher (5 H. and N. 769; 157 E.R. at p. 978) is thus summarised in 17*

*Hailsham, sec. 378, at p. 181 : “ An annuity is an income purchased with a sum of money or an asset which then ceases to exist, the principal having been converted into an annuity.” The test, in determining whether a series of annual payments amounts to an annuity, is whether the principal continues to exist as a debt or is liquidated when the transaction takes place.”*

[9] Mr. Meyerowitz, who appeared for the appellant argued that the capital amount of approximately R6 million was paid to B by the A Pension Fund on behalf of and for the benefit of the appellant. The fact that the payment came from a Pension Fund is only relevant in that it gave rise to the agreement that was entered into between the appellant and B. He argued that in determining the nature of the periodic payments regard must be had only to the terms of the agreement.

[10] Mr. Meyerowitz relied on the following provisions in the agreement for his contention that the periodic payments do not constitute an annuity:

- (a) B undertook to act as appellant’s agent in investing the capital in such units as the appellant chose.
- (b) Other than an initial fee and a continuing administration fee B had no proprietary or financial interest in the capital sum. The agreement specifically provides that although the units are

bought in the name of B, the units never belong to B and that members are therefore fully protected against any financial risk which B may incur. The growth and decline in the value of the investment is solely for the account of the appellant.

- (c) Subject to subtracting the fees referred to above, the capital sum plus the income earned was held solely for the benefit of appellant and after his death, that of his dependants, until both the income and capital is exhausted.

**[11]** Accordingly he argued that in terms of the agreement the appellant retains complete control as to the investment of the capital. With regard to the repayment of the capital the appellant retains, within the parameters of his agreement, complete say as to the amount repayable to him on a monthly basis.

**[12]** On the other hand, Mr. Stevens, for the Commissioner, argued that the funds invested with B did not vest in the appellant, but vested first in the pension fund and subsequently in B. For this argument he relied on section 14(1) and (2) of the Pension Fund Act, No. 24 of 1956. In my view these sections have no application to the present factual situation, and accordingly this submission does not warrant further discussion.

[13] Of more substance is his argument that the appellant was not the “*true owner*” of the investment because he could not draw the money at will. I am not sure what is meant by the term “*true owner*”. The mere fact that the appellant could not draw the money is not, in my view, decisive. There are many types of investments (which are not annuities) where the investor can only access his/her funds after a certain period or under certain specified circumstances. In this case the appellant and B agreed that his capital would be repaid in a specified manner.

[14] Having said that, there is no doubt that the agreement bears a likeness to an annuity. It is in fact clear that the appellant at all times thought that he was buying an annuity. The only question to decide, is therefore whether the terms of the agreement are such that it in fact constitutes an annuity. In doing so it must be borne in mind that the cases suggest that the main distinguishing feature is that in the case of an annuity the investor forgoes his capital in return for annual payments.

[15] Mr. Stevens sought, *inter alia*, to rely on the Hogan decision *supra* to substantiate his argument. This decision does not, in my view, support his argument. On the contrary it supports the appellant’s case. Firstly, the *dictum* in Commissioner for Inland Revenue v. Milstein referred to in paragraph 8 above, is adopted with approval at 159 F-H. From this it is

clear that the crucial question is not whether the investor can access his/her funds, but whether the capital ceases to exist and is converted into an annuity.

Secondly, his argument ignores the following *dictum* at 159 H – 160 C:

***“Die motorvoertuigongeluk waarin Hogan beseer is, het ‘n deliktuele skuld laat ontstaan uit hoofde waarvan die MVA-fonds aanspreeklikheid teenoor hom opgedoen het om sy toekomstige verlies van inkomste te vergoed. ‘n Eenmalige betaling van die skuld sou van ‘n kapitale aard wees wat die skuld sou uitwis. Insgelyks sou die verspreiding van die betaling deur ‘n aantal afbetalings ook van ‘n kapitale aard wees wat die skuld verminder totdat dit uitgewis is.***

...

***Die deliktuele skuld is deur die onderneming uitgewis sodat dit as’t ware ‘n transmutasie ondergaan het deur in die plek daarvan kontraktuele aanspreeklikheid te stel om die maandelikse paaielemente aan Hogan te betaal solank hy leef (tensy sy toestand sou verbeter) sonder om ‘n likwiede of bepaalbare skuld daar te stel wat deur die betaling van maandelikse paaielemente verminder word. By Hogan se afsterwe word geen kapitaalsom aan hom teruggegee nie anders as wat die geval met ander beleggings is.*** (Emphasis supplied)

**[16]** That really is the end of the enquiry. It is evident in my view 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 derived therefrom until the capital was exhausted. Accordingly it is not an annuity.

**[17]** In the circumstances the following order is made:

- (a) The appeal is allowed;
- (b) The assessment is set aside and the respondent is ordered to issue a revised assessment.

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**TRAVERSO, DJP**

**30 August 2005**