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The Governance, Taxation and Regulation of Beneficiary Funds in South Africa

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ABSTRACT: *A beneficiary fund is a pension fund established in terms of section 1 of the Pension Funds Act, 24 of 1956 for the purposes of a dependant of a deceased's member. A Beneficiary Fund is a legal entity that is setup in accordance with the Pension Funds Act for the purpose of accepting Section 37C death benefit payments. The Beneficiary Fund has a board of trustees who are there to ensure that the monies (or other assets) are administered with the necessary care for the benefit of the beneficiaries. It is an efficient and flexible way to ensure that assets are looked after. It also ensures that assets are objectively managed and controlled by the appointed trustees in the best interest of the beneficiaries. The beneficiary fund has its own rules, its own Board of Trustees and a Principal Officer (who reports to the board of trustees and is responsible for the daily running of the Fund). The paper discusses the legislative frameworks, taxation, governance and adjudication of complaints relating to beneficiary funds.*

Ketwords: Governance, Taxation, Beneficiary Funds, Pension Funds, South Africa

Introduction

A beneficiary fund is a fund established for the purposes of accepting lump sum death benefits awarded in terms of section37C of the Pension Funds Act, 24 of 1956 (the Act) to a beneficiary (dependant or nominee) on the death of a member, which are not paid directly to that beneficiary (or his/her recognized care giver or guardian in the case of a minor), or to a trust nominated by the member, or to the member's estate or to the guardian's fund. The object of the beneficiary fund is to receive, administer, invest and pay benefits on behalf of and to beneficiaries who become members of the fund.This replaces the previous payments to trusts and a fund can now only pay to a trust if the trust was nominated by the member, a major dependant or nominee; a person recognised in law or appointed by a court as the person responsible for managing the affairs or meeting the daily care needs of a minor or incapacitated major dependant or nominee. Any association of persons or business carried on under a fund or arrangement established with the object of receiving, administering, investing and paying benefits, referred to in section 37C on behalf of beneficiaries,

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payable on the death of more than one member of one or more pension funds is a beneficiary fund and must be registered by the Financial Services Board and approved.

Beneficiary funds were first mooted by the then Finance Minister Trevor Manuel in March 2007 following the Fidentia scandal which arose from glaring gaps in the regulation of umbrella trusts, which traditionally operated under the jurisdiction of the Master of the High Court. According to Nevondwe (2009), the aim was to beef up the regulation and supervision of beneficiaries' assets in order to avoid future loses, improve the protection of beneficiaries, and ensure that the trustees of trusts adhere to their fiduciary duties. Beneficiary funds were introduced by the Financial Services General Laws Amendment Act, 22 of 2008 particularly section 15(2) (a) which came into effect on 1 November 2008 and the beneficiary funds came into operation with effect from 1 January 2009.

These funds are governed by the Pension Funds Act 24 of 1956. Since 1 January 2009, death benefit payments need, by law, to be made into a beneficiary fund. When a member of a retirement fund dies, leaving children behind who are not yet 18, the trustees of the retirement fund have a duty to establish who the member's dependants are. They then have to decide how best to divide up and allocate the death benefit.

If a spouse has been left behind and is financially competent, it makes sense to pay the funds to him or her to manage on behalf of the minor children. If the surviving spouse as guardian is not financially competent to manage the minor dependants' money, the trustees have the option to pay it into a beneficiary fund. But if both parents are deceased and the children are cared for by a caregiver, the trustees will consider paying the funds into a beneficiary fund. This is because the chances are that there will be a different caregiver at some stage (for example, a grandmother may die and someone else will take over).

Beneficiary funds are mainly umbrella funds, which mean that they serve multiple retirement funds of different companies. They are properly regulated by the Act and members have recourse to the Pension Funds Adjudicator.

Since the 2008 amendments to the Pension Funds Act, the beneficiary funds were introduced with stronger regulatory framework. They have sufficient governance, reporting requirements and conduct annual audits.This regulatory framework will prevent the scandals like Fidentia scandal and misuse of funds as the case in the trust funds. Beneficiary funds are aimed at protecting the funds of widows and orphans.

Legislative framework

In 2008, the definition of "pension fund organization" in section 1 of the Act was amended to create a new type of fund known as a beneficiary fund. This fund is defined in section 1 of the Act as "a fund referred to in paragraph (c) of the definition of “pension fund organization”. Paragraph (c) in turn defines a pension fund organization as … “any association of persons or business carried on under a scheme or arrangement established with the object of receiving, administering, investing and paying benefits, referred to in section 37C on behalf of beneficiaries, payable on the death of more than one member of one or more pension funds”.

In terms of the above definitions, a beneficiary fund is a special fund that only receives, invests and administers benefits payable in terms of section 37C of the Act on behalf of beneficiaries. These benefits are paid into a beneficiary fund by trustees of pension and provident funds in terms of section 37C (2)(a) of the Act for the benefit of deceased members’ beneficiaries, particularly minor beneficiaries. In terms of section 37C(2) of the Act, payment into a beneficiary fund is deemed to be payment to the beneficiary concerned.

Although payment of a benefit into a beneficiary fund is deemed to be payment to a beneficiary, the opening words of section 37C(1) of the Act seems to suggest that in the event of the death of such beneficiary, the benefit payable from a beneficiary fund would again be payable in terms of section 37C of the Act. The opening paragraph of section 37C(1) states “Notwithstanding anything to the contrary contained in any law or in the rules of a registered fund, any benefit (other than a benefit payable as a pension to the spouse or child of the member in terms of the rules of a registered fund, which must be dealt with in terms of such rules) payable by such a fund upon the death of a member, shall, subject to a pledge in accordance with section 19(5)(5)(i) and subject to the provisions of section 37A(3) and 37D, not form part of the assets in the estate of such a member, but shall be dealt with in the following manner:”

Therefore, it appears that on the death of a beneficiary in respect of whom a benefit had been paid into the beneficiary fund the provisions of section 37C will apply. This is because, firstly, with effect from 1 January 2009, a beneficiary fund is required to be registered in terms of the Act in order for such fund to receive benefits from a pension or provident fund. Secondly, a beneficiary under the beneficiary fund falls within the definition of a “member” in section 1 of the Act.

Section 37C specifically provides that a benefit payable upon the death of a member a pension of provident may not form part of the estate of the deceased member other than the limited instances outlined in the section itself. Such circumstance are set out in Sections 37C(1)(b) and (c) of the Act. These provisions make it clear that there are only three sets of circumstances in which the benefit payable from a registered fund on the death of a member is to be paid to the executor of such member’s estate after the member’s death. One is where no dependant is found and the deceased member died without having nominated any beneficiary (bases on section 37C(1)(c). In this instance, the benefit must be paid to the executor or if no inventory has been filed with the Master of the High Court, the benefit is paid into the Guardian’s Fund. The second instance is where the estate of the deceased member is found to be insolvent, where no dependant is found, and the deceased member had nominated a

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beneficiary who was not a dependant (based on section 37C(1)(b)). The third one, which is also based on section 37C(1)(b) is where the deceased member has nominated a beneficiary to receive a portion of the benefit in which case the remaining balance of the benefit will be paid into the estate.

According to Nevondwe (2008), section 37C of the Act seeks to ensure that those who were dependent on the deceased member are not left destitute by that latter's death. To achieve this object, section 37C overrides the freedom of testation, and the board of management is not bound by the wishes of the deceased as expressed in the nomination form. For this reason, the death benefit subject to the exceptions outlined in section 37C is excluded from the estate of a deceased member and placed under the control of the retirement fund.

The board is not bound by the deceased's will or nomination form. So although the deceased may have expressed an intention to benefit a certain nominated beneficiary in the nomination form, this does not necessarily imply that the whole amount of the benefit will in fact be awarded to that beneficiary For the deceased's intention as contained in the nomination form is only one of the factors considered when allocating a death benefit. The section essentially imposes three primary duties on the board of management:

- to identify the dependants and nominees of the deceased member;
- to effect an equitable distribution of the benefit amongst the beneficiaries; and
- to determine an appropriate mode of payment.

The application of section 37C on the benefit payable from a beneficiary fund would unfortunately mean that the benefit originally paid into a beneficiary fund in terms of section 37C of the Act would be subjected to the same uncertain and onerous process prescribed in that section. Whilst the primary objective of this section is to protect dependants of the deceased member, it places a very onerous burden on the board and it is difficult to implement. In *Dobie NO v National Technikon Retirement Pension Fund*[1][1999] 9 BPLR 29 (PFA), the Pension Fund Adjudicator said "One thing is certain about section 37C, it is a hazardous, technical minefield potentially extremely prejudicial to both those who are expected to apply it and to those intended to benefit from its provisions. It creates anomalies and uncertainties rendering it most difficult to apply. There can be no doubt about its noble and worthy policy intentions. The problem lies in the execution and the resultant legitimate anxiety felt by those who may fall victim to a claim of maladministration in trying to make sense of it."

Only section 37C death benefits (approved benefits) payable by a registered fund for the benefit of a dependant or nominee may be paid to a beneficiary fund. This can be for a minor or major if considered appropriate by the retirement fund trustees. The regulator (FSB) main purpose in creating a new legal

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vehicle, the Beneficiary Fund, was to offer greater protection to dependants of lump sum benefits under the Pension Funds Act.

The beneficiary funds require the fund to perform the annual audit, the board to have independent trustee representation, the fund must report to FSB annually on financial statements, fund rules are registered and approved by the FSB, section 13B administrator licence, fund is FICA exempt and the fund has administration agreement with administrator setting out duties and service standards.

The objective of the beneficiary fund is to receive lump sum death benefits from transferor funds (approved funds) and administer them for the benefit of the beneficiary fund member (dependant). Approved funds include transfers from other registered beneficiary funds and trusts.

Taxation of beneficiary funds

Transfers to the beneficiary fund, are tax-exempt – receipt of transfer not subject to section 14 of the Pension Funds Act. Vesting in the beneficiary takes effect on date of transfer into the beneficiary fund. Payment to beneficiary is part of gross income and taxed in terms of PAYE scale. Fund withholds tax in terms of the Fourth Schedule of the Income Tax Act. Majority of payments to beneficiaries are below PAYE threshold and therefore no tax withheld. Tax implications on individual members of the pension fund will differ in respect of decision to pay to a beneficiary fund. This will be a relief to the beneficiary whom majority of them are found to be poor since they will have lost the breadwinner.

The investment income earned by the beneficiary fund will be tax-exempt and all benefit payments made to the beneficiary will be free of tax. The beneficiary fund appears to be a clear winner in the case of higher amounts. In respect of lower benefit amounts, it attracts absolutely no tax at any of the three points at which tax could possibly arise. As the lump sum death benefit increases, tax calculated in terms of the retirement / death table will reduce the net benefit received, but there is no tax on the income or benefit payments. Payments to a parent or a family trust will be less because the investment income is taxed in the beneficiary's hands. To do a more holistic comparison, one should take the costs of the beneficiary fund, trust and/or investment selected by the parent into account as well. Despite the latest amendments to the basis of taxation, beneficiary funds remain an exciting and tax-efficient new development, offering practical solutions with increased protection for minor dependants.

Governance of beneficiary funds

Beneficiary funds must comply with Regulation 28 of Pension Fund Act (prudential investment guidelines). It must have an investment policy in place. Beneficiary funds must adopt the principles of governance as set out in PF130 issued by the Financial Services Board and also has a code of conduct; an investment policy statement; a communication policy; and a performance assessment tool for trustees.

The governance of private pension plans and funds involves the managerial control of the organizations and how they are regulated, including the accountability of management and how they are supervised. According to Stewart and Yermo (2008), the basic goal of pension fund governance regulation is to minimize the potential agency problems, or conflicts of interest, that can arise between the fund members and those responsible for the fund‘s management, and which can adversely affect the security of pension savings and promises. Good governance goes beyond this basic goal and aims at delivering high pension fund performance while keeping costs low for all stakeholders. Good governance can have many positive side effects such as creating trust amongst all stakeholders, reducing the need for prescriptive regulation, and facilitating supervision. Good pension fund governance can also be conducive to more effective corporate governance of the companies that they invest in, as well-managed pension funds are more likely to seek value for their investments via a more active shareholder policy. Good governance also needs to be ‗risk-based'. For example, the more sophisticated the investment strategy the pension fund adopts, the stricter the governance oversight required; or the more complex the administrative arrangements of the plan, the tighter operational oversight needs to be.

Clark, Caelewy-Smith and Marshall (2005) believe that policymakers around the world have robustly debated the efficacy of a retirement fund governance model which relies heavily on the expertise of pension fund trustees. In a financial world of increasing complexity that demands high levels of expertise, it is widely believed that many trustees may lack the competence to make investment decisions consistent with the best interest of beneficiaries (members).Another problem is conflicts of interest in the way that trustees discharge their duties to the beneficiaries of the fund.

In 2007, the FSB issued a Pension Funds Circular 130 on good governance for retirement funds. Circular 130 requires that trustees put in place a documented code of conduct, an investment statement, communication strategy to members, and have a performance appraisal system for trustees. It also obliges new board members to receive comprehensive training and all board members to be trained on a continuing basis. Although the circular extensively covers elements relevant to the sound operation, conduct, duties and obligations of boards of trustees, it is not enforceable. The non-enforceability might be a concern because the industry and trustees might voluntarily adhere to the circular. It is Government's view that Circular 130 should be legally enforceable by the Registrar of Pension Funds, and therefore attain the status of a regulation that would be rigorously applied and complied with by boards of trustees.

The FSB has also launched an online education programme, known as the Trustee Toolkit, for the development and education of retirement fund trustees. The Toolkit is voluntary and may also serve as a useful reference for trustees, administrators of retirement funds, and anyone interested in retirement fund governance and management. The Toolkit is structured along the lines of the Pension Funds Circular 130

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(that is, governance by the board, governance of operations of funds, and management of stakeholder relationships), thus reinforcing the importance of good governance.

Adjudication of complaints relating to beneficiary funds

The adjudication of pension funds complaints rest with the Pension Funds Adjudicator. The Adjudicator has jurisdiction to deal with complaints relating to the administration of beneficiary funds. In terms of section 30D (3) of the Pension Funds Act, the main object of the Office of the Pension Funds Adjudicator is to dispose of complaints in a procedurally fair, economic and expeditious manner. The definition of complaint in the Act requires the complaint to relate to a fund. The beneficiary fund falls within the definition of a pension fund organisation.

A complaint must be lodged within three years of the act or omission that gave rise to the complaint (section 30I (1) of the Act).If the three year period has expired, the Adjudicator may not investigate the complaint.

There is a good reason for a limit to be imposed on the time during which litigation may be launched and the Constitutional Court has pronounced on this issue. As Didcott J explained in *Mohlomi v Minister of Defence*1997 (1) SA 124 (CC) *in* paragraph [11]:

> “Rules that limit the time within which litigation may be launched are common in our legal system as well as many others. Inordinate delays in litigation damage the interest of justice. They protract the disputes over the rights and obligations are sought to be enforced, prolonging the uncertainty of all concerned about their affairs. Nor in the end is it always possible to adjudicate satisfactorily on cases that have gone stale. By then witnesses may no longer be available to testify. The memories of ones whose testimony can be obtained have faded and become unreliable. Documentary evidence may have disappeared. Such rules prevent procrastination and those harmful consequences of it. They serve a purpose to which no exception in principle can cogently be taken.”

Similarly, it was held in *Vandeyar v UTICO Staff Pension Fund* [2000] 3 BPLR 332 (PFA) that the purpose of section 30I(1) of the Act is to ensure finality and certainty in pension fund affairs and to promote efficiency by an incentive for the prompt enforcement of complaints: “all legal systems accept that the operation of obligations should be limited by requiring enforcement with a reasonable period of time”.

Conclusion

The reasons why beneficiary funds were introduced is because there has been mismanagement and abuse of death benefits allocated to minors and widows by pension funds, held in trust, by trust funds.

For the moment, the beneficiary fund has not replaced the Trust Fund and payment of a benefit due to a beneficiary made by a fund into a trust fund is still regarded in terms of section 37C as payment to the beneficiary. Similarly, benefits held in trust by trust funds will still have to be distributed in accordance with their original mandate. Therefore, the responsibility of choosing a beneficiary fund over a trust fund and the safety accorded to beneficiaries of each institution lies with board of trustees of the transferor fund. History dictates that trust funds are not managed properlyand there are not approved by the FSB. Complainants or aggrieved persons does not have a recourse to lodge their complaint to the Office of the Pension Funds Adjudicator over trust fund issues which makes them to be more frustrated and not knowing where to seek assistance. If you have a complaint regarding the governance, operations and payment to beneficiary funds, you can now lodge a complaint to the Pension Funds Adjudicator which was not the case in the trust fund.

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