



Government Employees Pension Fund Board of Trustees

For approval

Clean-Break Principle

Submitted to:
Date approved:

Board of Trustees
14 April 2010





GOVERNMENT EMPLOYEES PENSION FUND
REPUBLIC OF SOUTH AFRICA

Memo

14 April 2010

THE ADOPTION OF THE “CLEAN BREAK” PRINCIPLE INTO THE GOVERNMENT EMPLOYEES PENSION FUND (GEPF)

1. PURPOSE

- 1.1. The purpose of this memorandum is to recommend that the Board of Trustees approves the adoption of the “clean break” principle into the GEPF using the approach outlined below and in Appendix A (“Note on Divorce May 2009”).

2. BACKGROUND

- 2.1. The clean break principle allows for the non-member spouse to claim a portion of the member's interest, in terms of the divorce order, at or around the date of divorce and not at the date of exit as is currently the GEPF practice. This principle was introduced through the amendment of section 37D of the Pension Funds Act and the Second Schedule to the Income Tax Act (Act 58 of 1952) with effect from 13 September 2007. Although the GEPF does not fall under ambit of the Pension Funds Act, it is however required to comply with the Revenue Laws Amendment Act (RLAA) which was promulgated on 8 January 2008.
- 2.2. In terms of the RLAA, the employee's tax payable on the non-member spouse's pension interest also accrues as a result of the accrual of the divorce settlement, that is, at or around the date of divorce. The RLAA is also deemed to have the retrospective effective date of 13 September 2007.
- 2.3. The GEPF's current practice which was in line with the wider retirement funds industry practice prior to the amendments also implies that no interest is currently payable on this benefit from the date of the divorce

order to the date of payment which results in severe prejudice to the non-member spouse.

- 2.4 It is important to note that maintaining current GEPF practice may result in reputational risk for the Fund and the Government in the sense that the Government has instituted a policy that the Fund does not follow but all other retirement funds must follow.
- 2.5 In order to comply with the tax laws, and for consistency, the GEPF will need to change its current practice to one where both the non-member's spouse's pension interest and the tax thereon accrue at the same date.
- 2.6 The Fund's actuarial consultants submitted a discussion document laying out various approaches on how the GEPF can change the current practice. This document was discussed at the last BA-C meeting and the committee recommended that an interim solution be devised.
- 2.7 The solution agreed with the actuarial consultants is one where the non-member spouse is paid the divorce settlement at the date that it accrues which will not be at exit but at or around the date of divorce. This will apply for all divorce orders received by the Fund after the effective date of rule amendments allowing the "clean break" principle into the Fund. However, instead of adjusting the member's pensionable service in order to take the payment into account, a debt equal to the divorce settlement and any tax paid by the member spouse, will be created against the member which is payable by the member when he/she exits the Fund from his/her exit benefits. This debt will be accumulated with interest as per the Fund's policy regarding interest on money owing to the Fund. It is hoped that the member's gratuity on exit will be sufficient to cover the debt. To the extent that the member's gratuity on exit is insufficient to cover the outstanding debt, the balance of the outstanding debt could be converted into service which will be deducted from the member's total service on exit prior to the finalization of the calculation of his benefit.

The choice of the member spouse: debt account or reduction of service

- 2.8 At its November 2009 meeting, the B&A Committee requested that the member be given a choice as to whether he/she would like to have his/her benefit adjusted by creating a debt account as explained in 2.7 above or by having his or her pensionable service reduced as a result of the divorce settlement and any tax thereon. Due to the complexity of allowing this choice and the difficulty of explaining the implications of this choice to members, it was decided at the Clean Break workshop held by the BA-C on 19 February 2010 that debt account approach will be adopted rather than giving the member a choice.

The choice of the non-member spouse: cash benefit or actuarial interest share on transfer to an approved fund

- 2.9 On resignation from the GEPF a member has a choice of either taking a cash resignation benefit or to transfer his/her actuarial interest to an approved retirement fund. At its November 2009 meeting, the B&A Committee also considered the same option for the non-member spouse on payment of the divorce benefit. However, at the Clean Break workshop it was decided that the cash resignation benefit will be used as the basis for calculating the divorce settlement rather than giving the non-member spouse a choice.
- 2.8 Appendix A ("Note on Divorce May 2009") gives more details of the proposed final approach as discussed with the actuarial consultants.

3. RECOMMENDATIONS

- 3.1. There are certain aspects of the approach that require decisions by the Board of Trustees. These aspects are listed below together with the recommendations for the Board's approval:

3.1.1 *Benefit to be used to determine the divorce settlement:* section 7(8) of the Divorce Act clearly states that the member spouse's resignation benefit should be used as a basis for calculating the non-member spouse's portion. The current practice is to make use of the GEPF's resignation benefit. This benefit doesn't reflect the member spouse's actuarial interest in the Fund, which in most cases is higher than the cash resignation benefit. However, the B&A Committee at the Clean Break workshop decided that the cash resignation benefit should be used as the basis for calculating a divorce settlement.

3.1.2 *Date of accrual of the divorce settlement – divorce orders received by the Fund prior to the effective date of rule amendments:* This is in respect of the divorce orders received by the Fund **prior** the effective date of the rule amendments allowing the "clean break" principle into the Fund.

It is recommended that the Fund pays **all divorces settlements that have already been received** (but not paid because the member has not exited) at a fixed date. This date should be the effective date of the necessary rule amendment allowing the "clean break" principle into the Fund. The idea is to "clean up" all the pending divorce orders and then all new divorce orders received by the Fund after this date will fall under the new provisions.

The following procedure should be used for these divorce orders:

- i. The Fund should send letters to all the non-member spouses within 45 days of this effective date, requesting the non-member spouse to make an election as to whether they want their portion of the pension interest in cash or transferred to an approved retirement fund.

- ii. The non-member spouse must within 120 days of being requested inform the Fund of his/her decision.
- iii. The Fund must pay or transfer the amount within 60 days of being informed.
- iv. If the non-member spouse fails to make an election within the 120 day period, the Fund must pay the amount directly to the non-member spouse within 30 days of the expiry of that period.
- v. If the Fund does not have the necessary details to affect payment, the money must be kept in the Fund (and accumulated with Fund returns) until an election is eventually made or the appropriate personal details are provided by the non-member spouse.

It is further recommended that the date of accrual of the settlement together with the tax thereon be either:

- i. the date that the non-member spouse makes an election as to whether they want to transfer the divorce settlement to an approved retirement fund or to his/her bank account; or
- ii. if the non-member didn't make an election, the expiry of the 120 days from the date that the Fund requests the non-member spouse to make an election, whichever comes first.

In terms of the SARS General Note 33, for all divorce order granted after 1 March 2009, the non-member spouse is responsible for the tax. Also, the amount of tax is calculated in terms of the new stand alone table applicable to withdrawal benefits.

However, the tax liability for all divorce orders granted prior to 13 September 2007 remains that of the member spouse.

3.1.3 *Date of accrual of the divorce settlement - divorce orders received by the Fund after the effective date of rule amendments:* This is in respect of divorce orders received by the Fund **after** the effective date of the rule amendments allowing the "clean break" principle into the Fund. In line with the Income Tax Act, it is recommended that the non-member spouse's portion accrues on the date that the Fund receives the divorce order. It is further recommended that:

- i. within 45 days of the Fund's receipt of the court order, the Fund asks the non-member spouse to elect whether he or she wants the benefit paid in cash or transferred to another fund;
- ii. the Fund gives the non-member spouse 120 days within which to advise the Fund of the election;
- iii. on the date on which the non-member spouse advises the Fund of the election pay or transfer the amount within 60 days;
- iv. if he or she fails to notify the Fund of her election within the 120 day period, pay the share within 30 days of the expiry of the 120 day period; or

- v. if the Fund does not have the necessary details to affect payment, the money must be kept in the Fund (and accumulated with Fund returns) until an election is eventually made by the non-member spouse.

3.1.4 What interest should be charged on the debt: It is recommended that interest payable on the debt as a result of the divorce settlement should be in line with the current policy governing interest payable on moneys owing by members to the Fund. It is further recommended that this interest be charged from the date that the member spouse's benefit is paid.

3.1.5 Late payment interest on the divorce settlement payable: It is recommended that interest be added from the date that the non-member spouse makes an election until the date of payment. It is recommended that the interest be in line with the Fund's interest rate policy.

3.1.6 Factors used to determine "divorce settlement service" for unsettled debt: In the case where a pension and a gratuity is payable on exit (i.e. if the gratuity is insufficient to cover the debt) or in the case where a member chooses adjustment of service rather than creation of a debt, it is recommended that actuarial interest factors be used to determine "divorce settlement service", to be subtracted from the member's total service, rather than purchase of service factors. This will then be the basis for adjusting the actual service that is used in determining the final benefits payable to the member. Any service enhancements due to members in terms of the rules will be calculated based on original service rather than adjusted service, thereafter the "divorce settlement service" will be deducted.

3.1.7 Flexibility to repay the debt: It is recommended that the member be given the flexibility to repay the debt during his/her period of active Fund membership.


General AL de Wit

Chairperson: Benefits and Administration Committee

Date: 14/04/10

Approved / Not approved / Comments



Mr A Moloto

Chairperson: GEPI Board of Trustees

Date: 2010-04-20

**INTRODUCTION OF THE CLEAN BREAK APPROACH WITHIN THE
GOVERNMENT EMPLOYEES PENSION FUND**

1. We refer to our initial note on the introduction of the “Clean Break” approach within the Government Employees Pension Fund (the “GEPF” or the “Fund”) prepared in February 2009, wherein the various issues that should be considered were set out, together with various approaches of implementing the clean break approach on divorce within the GEPF and the advantages and shortfalls of each of the approaches.
2. We have been informed that the GEPF would like to further consider adopting the methodology of setting up a debt account in respect of the payment of the divorce benefit to the non member spouse (together with any tax the member spouse may be required to pay on the amount). When the member spouse exits the Fund the balance of the debt account would be settled and the net benefit would be payable to the member. This approach was option 3 as set out in our previous note prepared in February 2009 to reduce the member spouse’s benefit for the portion of the benefit paid to the non-member spouse.
3. In line with this request, the purpose of this note is to:
 - Set out the methodology to reduce the member spouse’s benefit for the portion of the benefit paid to the non- member spouse; and
 - Set out the various considerations that the trustees would need to agree if this approach is to be adopted.
4. Firstly, we will set out the proposed methodology that is being considered. The next section of the note will consider the issues and items that need to be considered to implement the proposed methodology.

Methodology

5. On the date of accrual of a divorce benefit, in terms of a valid divorce order, the Fund would create a debt in respect of the amount payable (including, if any, tax payable by the member spouse) to a non-member spouse.
6. The debt amount would accumulate with interest to the date the member exits from the Fund (and reduced to the extent that the debt is partially repaid over the member’s remaining period of service in the Fund by additional contributions).
7. At the date of the Member Spouse’s exit from the Fund the total value of the benefit (including any enhancements) in terms of the exit rule would be determined. The value of the total benefit would then be reduced by the accumulated outstanding debt, and if required (in the case where a pension and gratuity benefit is payable) the “implied

service” of the residual benefit could be determined (to calculate the net pension and gratuity benefit payable).

8. Let us consider the following example to illustrate the methodology. A 53 year old “services” member has 25 years of service and a final salary of R 100 000. On divorce the total amount (including any tax) to the non-member spouse is R 187 500. A year later the member exits the Fund and transfers his benefit to a retirement fund. For purposes of this illustration let us assume that the final salary remains the same. The total benefit would hence be R 693 000 (R 100 000 x enhanced service $(26 \times 1.25 - 2.5) \times$ factor (0.231)). The net benefit payable would be R 693 000- accumulated debt value (R 187 500+interest- any payments made to settle the debt). If the net benefit was R 505 500 this benefit would be based on 21.9 years pensionable service.

Considerations

9. In order to implement the above method of reducing the member spouse’s benefit for the divorce benefit payable the following would need to be considered:
- Withdrawal Benefit- What Benefit is used to determine the divorce settlement?
 - Benefits payable: What benefit is payable if the “net service” is less than 10 years and the “pre divorce service” is more than 10 years?
 - Date of Accrual: What is the Date of Accrual of the divorce settlement within the Fund?
 - Interest payable: What interest should be levied on the debt?
 - Interest payable on the benefit payable to the Non-member Spouse: What and from what effective date is interest payable to the non-member spouse?
 - Settlement of the Debt: How will the debt be settled?
 - Factors: What factors are used to determine the “negative service” for unsettled debt?
 - Administration of the Debt
 - Communication to members: What additional communication is required?
 - Changes to the Rules of the Fund?
 - Tax treatment and the effects on Income Tax Act
10. Each of these items is discussed below.

Withdrawal Benefit- What Benefit is used to determine the divorce settlement?

11. The amount due to the non-member spouse on divorce is based on the stipulated share of the member’s withdrawal benefit at the date of divorce. Following the enactment of the Pension Funds Second Amendment Act, 2001 funds were required to pay members at least their “minimum benefit” on withdrawal. The minimum benefit is calculated using market yields at the date of exit, the intention being to estimate the value that reflects the member’s actuarial value in the Fund. The GEPP has not incorporated the notion of the “minimum benefit” into the rules in respect of withdrawal benefits payable to members of the Fund.
12. On resignation from the GEPP a member has a choice of either taking a cash resignation benefit or to transfer his/her actuarial interest to an approved retirement fund. In some instances the value of a member’s actuarial interest may be up to three times the value of the member’s cash resignation benefit. At the date of divorce such an

election would not be made and as such the Trustees would need to consider which benefit would be deemed to be the member's withdrawal benefit for this purpose.

13. To place a value on the liabilities of the Fund the actuaries would, following a decrement investigation, determine a set of assumptions that would be used. One of these assumptions being the proportion of members at each age group that would be expected to withdraw from the Fund and take a cash resignation benefit. It should be borne in mind that should the "deemed withdrawal benefit" used to determine the non-member spouse's benefit be taken to be the member's actuarial interest value it would likely result in an increase in the total cost of benefits payable by the Fund. This would need to be accounted for in actuarial liabilities of the Fund. To determine the likely effect of such a change the actuaries would need to analyse the number of divorce orders received per annum at each age group, split by gender. The reason for the increase would be that some allowance would be required to take account of the likely increase in actuarial interest benefits and the relative reduction in cash resignation benefits (given that a portion of actuarial interest has been paid out).
14. The Trustees could deem the withdrawal benefit for the application of the "clean break" principle to be the cash resignation benefit, which as we understand is currently being used by the Fund. Ultimately, the divorce attorneys would need to appreciate the quantum of the "withdrawal benefit" used to set the proportion allocated to the non-member spouse.

Benefits payable: What benefit is payable if the "net service" is less than 10 years and the "pre divorce service" is more than 10 years service?

15. If a member's total service (excluding the effect of divorce) would have been over 10 years and in terms of the rules of the Fund the member would have been entitled to receive a pension and gratuity from the Fund, whereas if the member has less than 10 years service he would be entitled to a gratuity only.
16. The Trustees of the Fund would need to consider what benefit is payable if a member's net service, after the allowance of the debt, is less than 10 years whereas the "pre divorce" service is greater than 10 years.
17. If the initial intention of the distinction between the lump sum retirement benefit for members with less than 10 years service or a pension and gratuity payable to members with more than 10 years of service was to reduce the administrative burden and cost related to paying small pensions then the way in which the member's "net benefit" is paid should be based on the number of years of residual service or "net service" at the date of exit.

Date of Accrual: What is the Date of Accrual of the divorce settlement within the Fund?

18. Currently, any amount payable to a non-member spouse would only accrue to the non-member spouse on the date the member spouse exits the Fund.
19. The Rules of the Fund would need to be amended to specify the date of accrual in respect of a benefit payable in terms of a valid divorce order. The amendment specifying the date of accrual would need to stipulate the date of accrual for two categories of divorce orders. These being, where the date of the divorce order is on or after the

effective date of the rule amendment and where the date of the divorce order is prior to the effective date of the rule amendment.

20. The Trustees, in stipulating the date of accrual should take cognisance of the accrual dates of these benefit payments for tax purposes. The date of accrual in terms of the Rules of the Fund should correspond to the accrual date for tax purposes.

Interest payable: What interest should be levied on the debt?

21. In terms of the option being considered, the Trustees would need to consider what interest is levied on the outstanding debt. There are possibly arguments for either Fund returns, based on the Notional Portfolio index of the Fund or some other measure of interest. It should however be borne in mind that the Fund does have an interest rate policy for when monies are due to the Fund.
22. Further, there should be equity between the policy of the interest levied on the outstanding debt and the interest payable on the outstanding benefit payable to the non-member spouse.
23. Given the Fund's interest rate policy and that the policy for monies owed to the Fund and by the Fund are currently based on repo +3% the interest levied could be set in line with the current interest rate policy of the Fund.

Interest payable on the benefit payable to the Non-member Spouse: What and from what effective date is interest payable?

24. In terms of the amendments to the Pensions Funds Act interest is payable on the outstanding amount due to the non-member spouse. The Act sets out different timeframes by which the non-member spouse is required to make an election as to how the benefit should be paid etc and from when interest is payable. As mentioned above the GEPF is not bound by the Pension Funds Act and hence could choose to adopt their own policy to interest payable on the outstanding amount. Below we have considered the two groups of divorce orders, being those prior to the effective date of the amendment to the rules of the Fund and those after the effective date.

Prior to the Effective Date

- 24.1 Currently the Fund would have many outstanding divorce orders payable when the member exits the Fund. In terms of the current policy no interest is allocated to the amount payable to the non-member spouse. The Trustees would need to consider the effective date from which interest (if any) would be payable in respect of amounts payable due to outstanding divorce orders. Would interest be payable from the date of accrual or the effective date of divorce?
- 24.2 It may be appropriate to consider that the historic divorce orders are on a no interest basis and hence if there are changes to the rules to allow a clean break then interest would only be payable from this date of accrual. This would ensure consistency with the treatment of divorce orders after the effective date of the amendments to the Rule of the Fund interest could be payable in line with the interest methodology adopted, being either from the date of accrual or at some later date (following the date of accrual).

After the Effective Date

- 24.3 Part of the objective of the introduction of the “clean break approach” on divorce is to ensure that the non-member spouse receives a “real value” benefit, as opposed to a nominal value that was determined at the date of divorce. As such the Pension Funds Act has been amended to pay interest on divorce orders from a specified point after the accrual date.
- 24.4 In drafting the amendment to the Rules the Trustees would need to decide whether the Fund would follow the method of paying interest as set in the Pension Funds Act or some other method. If the Trustees decide the amount payable in terms of the divorce order will be held as a debt in the Fund to be settled on the member’s exit, the interest charged to the debt account and the interest paid to the non-member spouse should be consistent, in terms of the effective date that interest would be applied from and the interest allocated. The Fund has a late payment interest policy in terms of monies owed by the Fund and to the Fund, and as such the interest policy on divorce order payments should be in line with the existing policy.

Settlement of the Debt: How will the debt be settled?

25. The member spouse is required to settle the debt that would arise following the payment of the divorce settlement. The debt could be settled at exit, whereby the amount of the debt is off set from the total value of the benefit payable to the member. This however may result in some instances where the gratuity benefit is insufficient to settle the full debt and the pension benefit may need to be reduced accordingly.
26. In a way to manage the debt, we would recommend that the member be required to make monthly payments in order to settle the debt. Any remaining balance at exit would then be settled at exit.
27. It is important that the amount that “accrues” for tax purposes be the net amount after the debt has been settled.

Factors: What factors are used to determine the “negative service” for unsettled debt?

28. Irrespective of the methodology used to settle the debt, there may be the need to reduce a member’s pension in order to settle the debt. Further, if the type of benefit payable to the member is determined by the “net service”, the “net service” would need to be determined. This net service would be the member’s accrued service at exit less the “negative service”. The question then remains how is the “negative service” to be determined?
29. The Fund has purchase of service factors that are used to determine the number of years of service a lump sum can purchase within the Fund. In line with this to ensure equity between the factors used to purchase service and to determine the “negative service”, the Fund’s purchase of service factors could be used to determine the service that relates to the benefit payable in respect of the divorce order, and loaded as “negative service” on the member’s record. This can be seen as the member “selling service” to the Fund.