How do you make your money?

By the Forensic Investigation Team of the Attorneys Fidelity Fund

As part of remaining transparent and accountable to their clients, practitioners are required by their rules to account to their clients at the end or termination of the mandate. This accounting to clients must include the reflection of interest earned on s 78(2A) investment and administration fees taken from that interest, inclusive of VAT where the firm charges VAT.

While we take full cognisance of the fact that the administration fees taken from interest earned on s 78(2A) are not the only source of income for the practitioners, this article seeks to address the shortfalls that have been identified around the administration fees on s 78(2A) investments.

Section 78(2A) investments

Clients entrust their monies with practitioners by paying it into the practitioner's s 78(1) trust accounts. When an attorney invests in s 78(2A) on behalf of a client, an interest-bearing account is opened with a bank or building society, he or she makes reference to the section and the name of the client on whose behalf the investment is opened. Funds are then transferred from the s 78(1) account into the s 78(2A) account, and the firm will make accounting entries to reflect this transaction. Money in s 78(2A) will earn interest, which should be posted to the accounting records on a regular basis. On withdrawal of the invested money, that money, together with the interest earned, must flow from the investment account back to the s 78(1) trust account before payments are effected. The practitioner is entitled to a reasonable administration fee on interest earned on these investments. The fee taken by the practitioner is income for the firm and must be transferred from trust account to business account of the firm. For VAT registered firms, VAT will be charged on this fee. The fee then forms part of the income disclosure by the firm to South African Revenue Service (SARS) in order to comply with SARS's regulations.

What happens in reality?

A number of instances have been noted where some firms do not treat the administration fees as they should:

• While practitioners are entitled to a reasonable fee for administering the investments, instances have been noted where practitioners do not take a reasonable fee but prejudice their clients of their money by taking an unreasonable fee. Although reasonable fee has not been defined, it stands to reason that a practitioner taking an amount that exceeds that paid to the client is not taking a reasonable fee, and such cases have been noted. To reflect this unfair scenario, let us take a hypothetical example:

– An investment of R 100 000 earns interest of R 8 000 (being 8% of the capital invested) from the bank. The practitioner takes R 5 000 (being 5% of the capital invested or 62,5% of interest earned) as administration fees and gives the client R 3 000 (being 3% of the capital invested or 37,5% of interest earned).

Should the practitioner have properly levied the administration fee on the investment, the scenario would have been different:

– Interest earned on the R 100 000 investment is R 8 000 (8% of the capital invested), practitioner levies 0,4% fee on investment, which equals R 400 (5% of 8% interest earned on investment) and client gets R 7 600.

• We have noted instances, especially in smalls firms with sole practitioners or partners, where administration fees are not transferred from trust to business accounts, instead trust cheques are written out in the practitioner(s') personal names and cashed. This results in income that should have been disclosed as such not being disclosed to the relevant authorities like SARS and taxes due on such money not paid, and this is fraud.

• Other instances have been noted where firms do not transfer the fees but open other s 78(2A) investment accounts wherein they reinvest the administration fees for the firm. Not only does this give rise to non-disclosure to relevant authorities like SARS, but it also opens up misuse of the s 78(2A) investment vehicle as there is no underlying transaction. Notwithstanding this, nothing precludes firms from using their income generated, including that generated from administration fees, from generating more money, but it should happen outside of s 78(2A), under business.

• Further instances have been noted where portions of administration fees earned on these investments are credited to fraudulently-created trust creditors under the pretence that these are monies paid in by trust creditors and payments are then made out of those matters.

All these instances that have been articulated in the foregoing section amount to fraud and can lead to prosecution of practitioners when found. This in turn can have very negative effects on the firm that may even lead to business failure and therefore closure.

Are they all s 78(2A)?

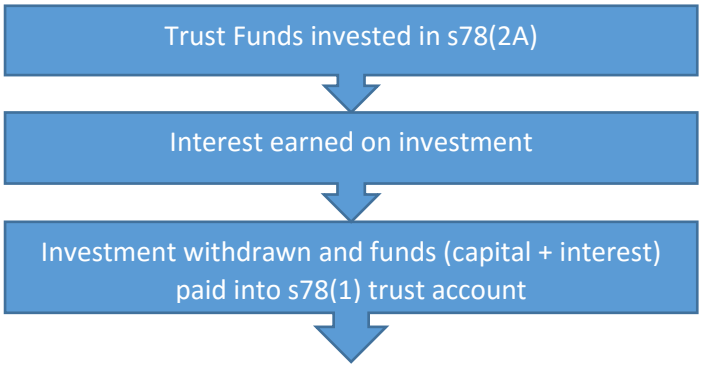
As it has already been highlighted above, s 78(2A) is used where there is an underlying transaction pending. We have noted on numerous occasions instances where practitioners have opened s 78(2A) accounts with no underlying transactions pending. This amounts to misuse of this investment vehicle. Such investments should be opened as pure investments as the client specifically paid in the money to be purely invested on their behalf. While the practitioner may charge an administration fee on such investments, these should be opened in terms of pure investments as anticipated in the various law societies' rules.

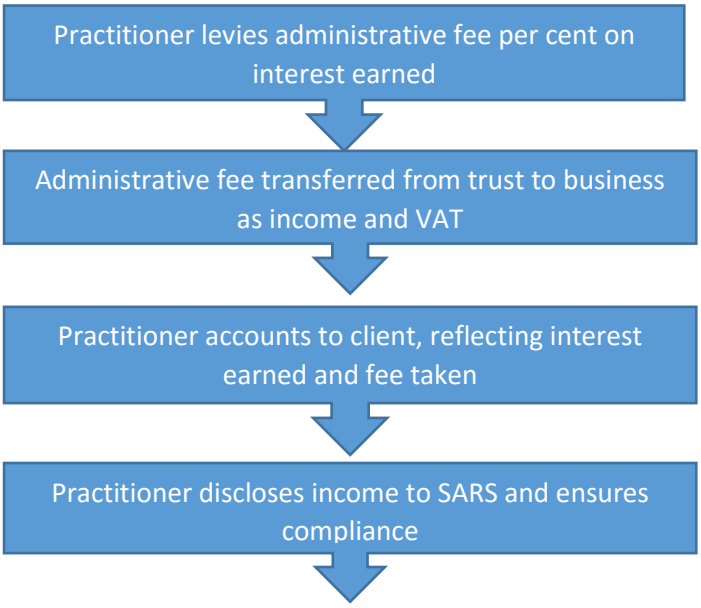
Does your client know?

Practitioners are required in terms of the rules of the various law societies to account to their clients on termination or completion of the mandate. In their accounting statements, they must explicitly reflect the interest earned in the investment and the administration fee taken by the practitioner/firm. A number of instances have been noted wherein the practitioners do not explicitly disclose this information to their clients. Where clients have given written instructions prior to the investment being made, it is prudent to clearly reflect in the mandate form what administration fee the practitioner will levy. This ensures transparency and prepares the client upfront of what to expect.

Conclusion

In conclusion, here is the flow that administration fees on s 78(2A) should follow:





As you continue to reap the rewards of your hard work, remember to do it within the applicable prescripts and remain reputable.