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REPUBLIC OF SOUTH AFRICA

CONVERSION OF MEDICAL DEDUCTIONS TO MEDICAL TAX CREDITS – TAX POLICY DISCUSSION DOCUMENT FOR PUBLIC COMMENT

NATIONAL TREASURY

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EXECUTIVE SUMMARY

This discussion document is published for public comment, and gives effect to the 2011 Budget tax announcement by the Minister of Finance to reform the current medical deduction allowances by replacing them with medical tax credits. Whilst this reform will be implemented in phases, it forms part of a comprehensive reform proposal – this document aims to facilitate consultation over the comprehensive proposal, and contextualises the phases for such reform.

The first phase of this reform is set out in the legislative amendments contained in the 2011 Draft Taxation Laws Amendment Bill (TLAB) published on 2 June 2011 (available on the treasury website www.treasury.gov.za). Whilst these legislative amendments will be open to the normal public comment process for the TLAB, this document explains the underlying rationale for the entire medical reform, explains the first phase, and then focuses on the tougher questions for consideration in subsequent phases, including for catastrophic and out-of-pocket medical expenses. There is a two-phase process for public comments: Firstly, public comment for the TLAB proposals on medical scheme contributions are invited by 22 July 2011, and a second round of comments for future options on out-of-pocket expenses by 31 October 2011, to cover the proposals in the second and later phases that are not covered in the 2011 Draft TLAB. The key features of the present arrangements are discussed below.

Relief in the form of deductions from income is afforded to taxpayers for medical scheme contributions and out-of-pocket medical expenses. Medical scheme contributions by an employer on behalf of an employee are included as fringe benefits in the hands of the employee (taxpayer). Contributions to registered medical schemes are allowed as a deduction up to prescribed monthly capped amounts. Medical scheme contributions in excess of the caps, plus qualifying out-of-pocket medical expenses, can be claimed as a further deduction to the extent that they exceed 7.5 per cent of taxable income. Taxpayers aged 65 and above, or who have a disability or have an immediate family member with a disability, may deduct their medical expenses in full.

While the current deductions regime serves both to provide relief for those taxpayers contributing to medical schemes and protects families against catastrophic health expenditure, it is inequitable in that it affords a greater benefit to higher income taxpayers for necessary services like health, through the effect of the progressive marginal rate structure. It is proposed that deductibility of medical expenses should be replaced by tax credits, the value of which will be unrelated to a taxpayer's income bracket. The principle difference between a tax deduction and tax credit is that medical tax credits reduce a taxpayer's tax liability, whereas deductions reduce a taxpayer's taxable income. Lower income taxpayers will therefore gain from such change, whereas higher income earners will benefit less than at present. The underlying principle behind the proposed change is fairness, and the new system is proposed as a step towards an equitable fiscal contribution to health insurance for all South Africans. In this respect, this proposal also facilitates the longer term goal of universal National Health Insurance.

In proposing policy options National Treasury aims to achieve the following policy objectives:

- Equity and proportionality, particularly in enabling taxpayers across income groups to access healthcare
- Fairness
- Alignment with National Health Insurance objectives
- Affordability and fiscal sustainability
- Administrative simplicity

Proposals relating to Medical Scheme Contributions (for adoption in 2012)

This discussion document explains the 2010 proposals which are intended to take effect on 1 March 2012. These are incorporated in the 2011 Draft Taxation Laws Amendment Bill (available on the treasury website at www. treasury.gov.za), and comprise:

- A medical scheme contribution credit will be available to taxpayers who belong to a medical scheme, set at a fixed amount per month for the taxpayer and first dependant, and two-thirds of this amount for additional dependants, adjusted annually for inflation. In 2011/12 values, amounts of R216 each a month for the taxpayer and first dependant, and R144 a month for each additional dependant, are proposed.
- A supplementary medical scheme contribution credit of R216 a month is proposed for members or dependants aged 65 and above, and members or dependants with a disability.

In addition, this document also seeks to explore the way forward on the tax treatment of out-of-pocket medical expenditures. Some of the key considerations are:

- When and how these expenses should be converted into credits;
- What should the phase-in period be for converting such deductions to credits;
- To what extent taxpayers and particularly vulnerable groups will be adversely affected by policy changes, and how these could be mitigated; and
- What the level of thresholds for credits should be, and what thresholds should be considered for taxpayers aged 65 years and older or those with disabilities.

In order to facilitate public comment on these important issues, three options are presented in this document for illustration. A few examples of policy options are evaluated according to how well they adhere to key policy objectives.

The current system, by way of medical scheme contribution and expense tax benefits (deductions), cost the fiscus an estimated R15.7 billion in 2008/09 terms. The proposals contained in this document are designed to maintain this level of tax expense benefit and seek to spread the benefit more evenly across income groups.

Medical tax credits will be non-refundable. It is envisaged that once the proposed Risk Equalisation Fund is in place as part of National Health Insurance reform, consideration will be given to the possibility of extending the benefit of the medical scheme contribution tax credit to those who fall below the tax threshold or who qualify for credits that exceed their tax liability, subject to practicality and affordability.

The public is invited to comment on the proposals contained in the discussion document. Comments may be submitted to Suzan Papo at email address suzan.papo@treasury.gov.za

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TABLES (cont.)

1 PURPOSE

This discussion document is published for public comment, and gives effect to the 2011 Budget tax announcement by the Minister of Finance to reform the current medical deduction allowances by replacing them with medical tax credits. As indicated in the 2011 Budget Review (p 68):"*The monthly deductions for contributions to medical schemes and for qualifying out-of-pocket medical expenses will be converted into tax credits effective 1 March 2012*".While this reform will be implemented in phases, it forms part of a comprehensive reform proposal – this document aims to facilitate consultation over the comprehensive proposal, and contextualises the phases for such reform.

The proposed change will bring about a more equitable fiscal contribution to meeting the costs of health care. Further refinements to these arrangements may be made in future, as part of the broader fiscal arrangements for phasing in a National Health Insurance (NHI) system.

The first phase of this reform is set out in the legislative amendments in the 2011 Draft Taxation Laws Amendment Bill (TLAB 2011) published on 2 June 2011 (available on the treasury website www.treasury.gov.za). In addition to proposals relating to medical scheme contributions that are contained in the TLAB 2011, this document also seeks to explore the way forward on the tax treatment of out-of-pocket medical expenditures. Public comment is invited for both the proposals contained in the 2011 TLAB, and the wider reforms mentioned in this document. The consultation process for these proposed reforms will be conducted until 31 October 2011.

2 BACKGROUND

Tax relief in the form of deductible allowances is currently afforded to taxpayers for medical scheme contributions and out-of-pocket medical expenses.

For taxpayers under the age of 65, contributions to registered medical schemes (including contributions by an employer on behalf of an employee) are allowed as a deduction from income, up to prescribed monthly capped amounts. Qualifying out-of-pocket medical expenditure, plus medical scheme contributions in excess of the caps, can be claimed as a deduction to the extent that the aggregate exceeds 7.5 per cent of taxable income.

In the case of taxpayers 65 and older, and taxpayers with a disability or taxpayers with a spouse or child with a disability, medical scheme contributions and qualifying medical expenses can be fully deducted from taxable income.

Medical scheme contributions paid by an employer on behalf of an employee under the age of 65 were formerly treated as taxable fringe benefits only insofar as they exceeded the allowed contribution caps. Medical scheme contributions paid and health services provided by an employer to a retired former employee, or to dependants of a deceased former employee, remain fully exempt.

A proposal for revision of these arrangements was announced at the time of the 2009 Budget. Chapter 4 of the 2009 Budget Review states:

> *"Replacement of the medical scheme contribution deduction with a non-refundable tax credit is currently under consideration. To be broadly neutral in its overall impact, the tax credit would be set at about 30 per cent of the prevailing deduction. Where medical expenses in addition to contributions to schemes qualify as deductions, the credit would also be set at 30 per cent of allowable expenses. Implementation is proposed in two years' time so that SARS, employers and payroll providers will have sufficient time to make the necessary*

> *administrative adjustments. In preparation for this proposal medical scheme contributions will cease to qualify as tax-free fringe benefits. All contributions paid by an employer will be regarded as taxable and the employee will be permitted to claim a tax deduction (or a credit) for contributions up to the cap. The net tax effect of this step should be neutral for both employee and employer. The monthly caps have given rise to some compliance and administrative difficulties for both employers and SARS. These will be investigated to determine whether a legislative intervention is required."*

While the current regime seeks to provide relief for those taxpayers contributing to a medical scheme, as well as relief in the event of "catastrophic" health expenditure, it does so inequitably in that the tax benefit associated with deductible allowances is greater for taxpayers in higher income brackets, as a result of the progressive marginal rate structure.

In 2008/09, the total estimated tax benefit of medical deductions and exempt contributions by employers was estimated to be R15.7 billion. This includes 2.65 million individuals benefiting from a medical deduction totalling approximately R7.0 billion, and 39 700 individuals benefitting from disability-related deductions amounting to R389 million. Medical scheme members also benefited from capped contribution allowances paid by employers, with an estimated tax value of R7.4 billion in 2008/09. Medical scheme contributions by employers on behalf of retirees or dependants of deceased former employees accounted for a further tax benefit estimated at R896 million, mainly accruing to taxpayers aged 65 and older.

The proposals contained in this document are designed to maintain this level of tax expense benefit, but seek to spread the benefits more evenly across income groups. The underlying principle behind the proposed policy shift is equity in the tax treatment of medical expenditure, irrespective of the tax bracket into which taxpayers fall. South African personal income tax currently has six brackets, with the marginal rate of tax rising from 18 per cent in the lowest bracket to 40 per cent on taxable income of R580 001 and above (2011/12). The tax benefit associated with medical expense deductions therefore rises with higher taxable income. A tax credit, in contrast, benefits taxpayers with equivalent medical expenses equally, without regard to their taxable income levels.

A tax credit can be a specific amount in rand terms or a calculated value, determined as a percentage of the taxpayer's qualifying medical expenses, for example. The proposed reform incorporates elements of both approaches. A tax credit can be refundable, thus leading to a cash subsidy in the event that tax liability falls below zero. For administrative and fiscal cost reasons this is not proposed at this stage, though it is a possible further step towards a National Health Insurance system.

3 CURRENT TAX TREATMENT OF MEDICAL EXPENDITURE

For the tax treatment of medical expenditure, the South African Income Tax Act currently recognises three classes of taxpayers: those under the age of 65 years, those 65 years and older, and those who have a disability or who have an immediate family member with a disability. Section 18 and related

provisions of the Act, which define qualifying medical expenses and limitations on the quantum of deductible allowances, are reproduced in Annexure A, and are summarised in Annexure B.

Below 65 years

As provided for in section 18(1)(a) and 18(2)(c)(i) of the Income Tax Act, taxpayers may deduct their contributions to registered medical schemes or funds with similar provisions, subject to monthly caps that are adjusted annually.[1] Such contributions may be for the benefit of the taxpayer, his or her spouse and any other dependant[2] as defined in the Medical Schemes Act, 1998. Employer contributions to employee medical schemes are added to the taxable income of the employee as a fringe benefit. Employees (taxpayers) can claim a deduction of medical scheme contributions up to the capped amounts, regardless of whether these contributions are made by the employee or by the employer on his or her behalf. The capped amount deduction is available to medical scheme (or similar fund if abroad) members only.[3]

Taxpayers who do not have medical scheme membership can deduct qualifying out-of-pocket medical expenses to the extent that such expenditure exceeds 7.5 per cent of taxable income (section 18(2)(c)(ii) of the Income Tax Act). This relief is also available to medical scheme members, to the extent that the aggregate of the disallowed medical scheme contributions and out-of-pocket qualifying medical expenses exceed 7.5 per cent of taxable income. Such expenses must relate to the taxpayer, his or her spouse or his or her children, or any dependant of the taxpayer if the taxpayer is a member of a medical scheme and that dependant is, at the time such amounts are paid, admitted as a dependant of the taxpayer in terms of that scheme or fund.

65 years and older

Section 18(2)(a) of the Income Tax Act sets out the medical expenses tax treatment for taxpayers who are 65 years of age or older. (Persons over the age of 65 constitute about eight per cent of taxpayers subject to assessment.) He/she may claim all out-of-pocket qualifying medical expenses and contributions to a registered medical scheme in full as a deduction with no capped amounts restriction. Such expenses must relate to the taxpayer, his or her spouse or his or her children, or any dependant of the taxpayer if the taxpayer is a member of a medical scheme and that dependant is, at the time such amounts are paid, admitted as a dependant of the taxpayer in terms of that scheme or fund.

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[1] The capped amounts for 2011/12 are R720 per month for the taxpayer and first dependant and R440 for each additional dependant.

[2] According to the Medical Schemes Act of 1998, **"dependant"** means -

(a) the spouse or partner, dependent children or other members of the member's immediate family in respect of whom the member is liable for family care and support; or

(b) any other person who, under the rules of a medical scheme, is recognised as a dependant of a member.

[3] The relevant sections are s18(1)(a) and s18(2)(c).

Disability

In terms of section 18(2)(b) of the Income Tax Act, where the taxpayer, or his/her spouse or child is a person with a disability,[4] provided the disability is confirmed by a duly registered medical practitioner in terms of defined criteria, all contributions to a registered medical scheme may be claimed as a deduction. These contributions are not subject to any capped amounts. In addition, any out-of-pocket expenditure on qualifying medical expenses can be deducted from the taxpayer's taxable income in full. (If the taxpayer supports a non-immediate family member/friend who is a person with a disability, the full deduction is not permitted: such qualifying expenses can only be deducted to the extent that they, in aggregate with the disallowed contributions, exceed 7.5 per cent of the taxpayer's taxable income.)

Table 1 illustrates how the current deductions framework is applied, for taxpayers in different income brackets, with or without medical scheme membership. Cases 1-7 are taxpayers under the age of 65, with a dependent spouse and two children; cases 8-10 are taxpayers over age 65 or with a disability or a disabled dependent. The calculations take into account the 2011/12 medical scheme contribution caps, i.e. R720 each per month for the taxpayer and first dependant and R440 for each additional dependant. The capped allowable annual deduction for a family of four is R27 840.

Tax relief through the current medical deductions system provides relief for those taxpayers contributing to a medical scheme, though the benefit is greater for higher income groups as a higher marginal tax rate results in a greater reduction in tax liability. In effect, the tax saving is equal to the product of the taxpayer's marginal rate and the allowable medical expenses deductions.

The tax saving associated with out-of-pocket expenditure (or medical scheme contributions in excess of the deductible cap) depends on two partially offsetting factors – the expenditure threshold of 7.5 per cent of taxable income, and the marginal tax rate, both of which rise with taxable income. The examples included in table 1 illustrate how increased tax relief arises from higher out-of-pocket expenditure, for taxpayers in the same taxable income bracket.

[4] Defined in s18(1)(d).

Table 1: Current system of medical deductions – illustrative examples*(2011/12 values)*

	1	2	3	4	5	6	7	8	9	10
	No Medical Scheme		*Medical Scheme Contributor <age 65 (Member + 3 dependants)*					*Age 65+ or with Disability*		
Taxable Income (TI)	**150 000**	**150 000**	**150 000**	**300 000**	**300 000**	**600 000**	**600 000**	**150 000**	**300 000**	**600 000**
Marginal tax rate (A)	18%	18%	18%	30%	30%	40%	40%	18%	30%	40%
Medical scheme contribution	-	-	23 000	40 000	40 000	56 000	56 000	-	40 000	56 000
Out-of-pocket qualifying expenses	16 000	30 000	8 000	8 000	30 000	10 000	50 000	24 000	20 000	40 000
Total medical expenditure	16 000	30 000	31 000	48 000	70 000	66 000	106 000	24 000	60 000	96 000
Capped deduction	-	-	23 000	27 840	27 840	27 840	27 840	-	-	-
Excess contribution (above cap) plus out-of-pocket qualifying expenses	16 000	30 000	8 000	20 160	42 160	38 160	78 160	-	-	-
Excess expenses threshold	11250	11250	11250	22500	22500	45000	45000	-	-	-
Additional deduction	4 750	18 750	0	0	19 660	0	33 160	-	-	-
Total deduction (B)	4 750	18 750	23 000	27 840	47 500	27 840	61 000	24 000	60 000	96 000
Tax relief (AxB)	**855**	**3 375**	**4 140**	**8 352**	**14 250**	**11 136**	**24 400**	**4 320**	**18 000**	**38 400**
% of Taxable income	0.6%	2.3%	2.8%	2.8%	4.8%	1.9%	4.1%	2.9%	6.0%	6.4%
% of Total medical expenditure	5.3%	11.3%	13.4%	17.4%	20.4%	16.9%	23.0%	18.0%	30.0%	40.0%

Table 1 illustrates that taxpayers aged 65 and above or with dependants with a disability, or who themselves have a disability, benefit from substantial relief relative to taxable income, and by comparison with taxpayers under the age of 65. It should be noted that this benefit includes tax relief related to medical expenditure on dependants who are not over the age of 65 or have a disability. Taxpayers under the age of 65 do not qualify for corresponding relief in respect of medical expenditure associated with dependants over the age of 65.

4 THEORETICAL UNDERPINNINGS OF MEDICAL TAX CREDITS

Purpose-specific tax relief measures are included in most personal income tax systems of other countries. Such measures can take the form of exempt income, deductible expenses, tax rebates or tax credits. Tax relief is commonly provided for medical expenditure or health insurance, though there is considerable variation internationally in the form and extent of such measures.

Allowing medical expenses as a deduction from taxable income is, in effect, a recognition of these outlays as in part a "necessary cost" incurred in the maintenance of an individual's productive capacity, or the household's fundamental wellbeing. The underlying notion is that health-related expenditure is akin to a production cost rather than a discretionary consumption outlay in the household accounts. It places households on an equivalent footing for tax purposes, *after* recognition of medical expenses or insurance contributions as a deduction from income.

While this gives expression to *horizontal* tax equity in this respect, it has unsatisfactory consequences from a *vertical* equity point of view. In a progressive tax system (such as the South African personal income tax system), the net tax relief afforded through a deduction of qualifying expenditure provides greater benefits to higher income taxpayers. A system of rebates or tax credits, in contrast, results in tax relief that is equitable across income groups – the underlying idea is that the fiscus should contribute to household medical expenditure on the basis of health needs, irrespective of income or economic output. The international tendency is to move away from tax deductions to tax credits or rebates as relief measures consistent with the recognition, in respect of medical expenses, of the priority of vertical over horizontal equity considerations.

The argument that in a progressive tax system there should also be a rising marginal value of the health expense benefit (ie a regressive tax expenditure) is therefore not valid on three grounds. Health needs are inversely related to income. Medical insurance (and therefore pooling of risks) is

available to the rich. Thirdly, it is economically inefficient to distort the price of health expenditure by a greater margin for the rich than for the poor.

It seems clear, furthermore, that household expenditure on medical care and services involves both necessary and discretionary outlays. Concern about the impact of tax relief on the demand for health services provides further grounds for adopting a credit or rebate rather than a deduction regime.

The essential difference between deductions and credits in a personal income tax (PIT) system can be straightforwardly illustrated. Following Howell Zee,[5] if a country has a single rate (τ) governing its PIT regime, then the value of the tax credit (*c*) is equivalent to a deduction (*d*), where $c = \tau \cdot d$. If the PIT has multiple rates, the value of a deduction will depend on the taxpayer's applicable marginal rate – the higher a taxpayer's marginal rate, the more valuable the given deduction. However, the value of a specific credit (*c*) remains the same irrespective of the taxpayer's marginal rate of taxation.

It follows that a deduction regime has the unintended effect of disproportionately encouraging health expenditure by higher income taxpayers. This distortion has no obvious useful purpose – indeed, it arguably contributes to over-consumption or unnecessary utilization of scarce health resources. Smart & Stabile[6] argue that "Despite the fact that many countries allow individuals to deduct some portion of their direct medical expenses from taxable income, the elasticity of demand for medical care and medical insurance in such contexts remains at best poorly understood".

A review of the options in the Canadian context (Reuber & Poschmann[7]) concludes that a tax credit provides a more satisfactory approach because it is easier to administer than other options, and it can be designed to provide individuals with appropriate incentives relating to health care management while contributing significantly to the fairness and financial stability of the public health funding system. It should also be noted that medical tax credits can either be refundable or non-refundable. Non-refundable medical tax credits cannot reduce the amount of tax owed by a taxpayer below zero. The tax credit must be deducted from the tax liability and cannot be rolled over or result in a refund when it amounts to more than the tax liability. A refundable credit is more complex and expensive to administer, as it has the effect of extending a fiscal subsidy to households who fall below the income tax threshold.

5 INTERNATIONAL EXAMPLES

In exploring options for the reform of South Africa's tax treatment of medical expenses, practice in other countries provides useful points of comparison. Medically-linked tax credits are available in several other countries, including Canada, the Republic of Ireland and the United States of America. Key features of the approaches adopted in these countries are noted below.

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[5] Zee, H.H. 2005. Personal Income Tax Reform: Concepts, Issues, and Comparative Country Developments. IMF Working Paper – WP/05/87

[6] Smart, M & Stabile, M. 2003. Tax Credits and the Use of Medical Care. NBER Working Paper No. 9855

[7] Reuber, G. &Poschmann, F. 2002. For the Good of the Patients: Financial Incentives to Improve Stability in the Canadian Health Care System. C.D. Howe Institute.

Canada provides health expenditure relief through three medical tax credits: the medical expense tax credit, the non-refundable disability credit and the attendant care expense deduction. A notable feature of the Canadian system is that the tax credit applies equally to premiums for private health insurance plans and to taxpayers' out-of-pocket medical expenses.

The Canadian medical expense tax credit is a non-refundable credit, calculated as 15 per cent (the lowest tax rate) of the allowable portion of medical expenditure. The allowable portion of qualifying expenditure is the portion that exceeds the lesser of 3 per cent of the individual's net income for the year or an indexed dollar threshold (CAD 2 052 in 2011). There is no limit on the amount of eligible expenses a taxpayer can claim for himself or herself, a spouse or common-law partner or a child under 18 years of age. There is currently a CAD 10 000 limit applicable to a "dependent" relative; however, Budget 2011 proposes to remove this limit on eligible expenses that can be claimed under the Medical Expenses Tax Credit in respect of a dependent relative. Qualifying expenses can include expenditure incurred outside of Canada. A refundable credit is available to low-income workers who incur high medical expenditures.

The Republic of Ireland has adopted an interesting approach to co-funding health insurance through the fiscus: 'tax relief at source' is granted for premiums paid to authorised private health insurance schemes by requiring subscribers to pay 80 per cent of the gross amounts, which is equivalent to a medical tax credit of 20 per cent. Further medically linked tax credits are available in specific circumstances – people aged 50/older, incapacity, blindness, and the requirement of a home carer or guide dog.

The United States has a form of medical credit called the Health Coverage Tax Credit (HCTC), targeted at specific categories of lower income taxpayers. This benefit pays 80 per cent of a qualified health plan premium for eligible individuals.[8]

A more detailed account of the medical tax credit arrangements in these three countries is included as Annexure D.

6 REFORM OF SOUTH AFRICA'S TAX TREATMENT OF MEDICAL EXPENDITURE

OBJECTIVES

In considering options for the conversion of South Africa's medical expense deduction into a tax credit arrangement to achieve greater equity in the taxation system, account must be taken of the intended phasing in of a National Health Insurance system, through which funding for agreed health benefits will be shared and pooled across the community at large. There are thus five objectives that underlie the proposals to follow:

- *Equity and proportionality* – Tax relief should be equitable across income groups, and fair in proportion to average direct government spending on health services available to people without medical scheme coverage
- *Alignment with National Health Insurance objectives* –Tax relief for medical expenditure should be adapted, over time, to support the phasing in of National Health Insurance.

[8] In order to be eligible, certain requirements must be met and taxpayers must have a qualified health plan.

- *Fairness* –Taxpayers must contribute to the fiscus in proportion to their ability to do so. Therefore people of equivalent means must pay equivalent amounts of taxes.
- *Affordability and fiscal sustainability* – Tax relief must be provided in a way that does not cause undue pressure on the fiscus. While greater tax relief will assist taxpayers more, it may not be sustainable to the fiscus in terms of cost, and may cause distortions in the allocation of scarce resources.
- *Administrative simplicity* – Tax policy must be understandable to taxpayers, and also simple to administer. Administrative simplicity is more cost efficient, and leaves fewer opportunities for dispute.

Equity and proportionality

The proposed shift to a system of medical expense tax credits will result in a medical scheme contribution tax relief system that is more equitable across income groups. Present tax arrangements are not fully satisfactory, in that the value of tax relief depends on the tax bracket and hence the income level of taxpayers.

It should be noted that medical expense tax relief benefits households mainly in the upper quintile of the income distribution: whether as members of medical schemes or not, the relief is accessible only to individuals whose incomes are above the tax threshold.

It is therefore pertinent to take public expenditure on health services, of about R78 billion in 2008/09, as a relevant benchmark. This amounts to about R1600 a year per person, or R1950 a year for South Africans who are not covered by medical scheme membership. The present tax relief deductions, expressed as tax foregone per medical scheme beneficiary, amounted to an estimated R1 600 per person in 2008/09.

The overall tax relief on medical expenses is therefore broadly proportional on a per capita basis, by comparison with public expenditure on health services targeted at those without medical scheme coverage. The overall structure of health financing arrangements is redistributive, in that public health services are financed from general tax sources rather than membership contributions or patient fees.

The equity impact of the proposed medical expense tax credit regime could be further enhanced were it extended to include a refundable credit, available to contributors below the tax threshold. It nonetheless offers significant equity advantages over the present arrangements, in that it provides:

- Relatively greater tax relief for medical expenditure of lower income households,
- Enhanced tax relief for medical expenditure by the elderly,
- Enhanced tax relief for medical expenditure on persons with disabilities, and
- Tax relief for households confronted with high medical expenses, at a declining rate as taxable income increases.

Alignment with National Health Insurance objectives

The establishment of National Health Insurance will involve far-reaching changes to arrangements in both the public and private sectors. A level playing field between the public and the private sectors in the provision of hospital care and medical services will require substantial restructuring of the organisation and tax treatment of health services. The role of medical schemes and the regulatory framework to which they are subject will undergo further reform. The details of these changes have not yet been fully elaborated. The reform will in due

course result in a pooled, universal funding framework for medical services, either as a single fund or a multi-payer arrangement.

The implications for the tax system are not yet clear and the tax treatment of income-related contributions, if required, have yet to be determined. Without pre-empting the specific form or tax implications of the future National Health Insurance system, therefore, the proposed reform is consistent with its objectives and principles. The shift to tax credits will also facilitate the transition of medical schemes into a National Health Insurance framework, in that the fiscal contribution is transparent, equitable and limited, and likely to be in line with or less than overall insurance costs per person.

At present, contributory medical schemes and employer-funded health benefit arrangements provide health insurance or managed health services to less than 20 per cent of the population. Benefits and membership costs vary considerably, though registered medical schemes are obliged through prescribed minimum benefit regulation to cover diagnosis and treatment of some 300 specified conditions, including medical emergencies and scheduled chronic conditions. For those who do not have medical scheme insurance, public hospitals, clinics and health centres provide services and medicine that are largely free at the point of service, paid for out of general government revenue. Use of private health services in the event of serious medical or surgical needs is prohibitively expensive in the absence of medical scheme cover, and in critical cases can lead to impoverishment.

The approach proposed for this reform of the personal income tax is to keep the tax treatment of medical expenditure simple and adaptable, to align relief to clear health policy objectives and to ensure that arrangements are equitable and proportionate, taking into account affordability across the entire community and not limited to the present medical scheme client population.

Tax relief for supplementary medical scheme contributions and out-of-pocket medical expenses is likely to fall away under the NHI system, though a transitional period of phasing-out might be required. As an interim step towards National Health Insurance, it is proposed that the present medical expense deductions should be replaced by tax credits that are equitable in treating taxpayers equally irrespective of their taxable income bracket, and that are broadly proportional in value by comparison with an affordable level of national health expenditure.

Extension of the proposed reform to allow for a refundable medical scheme contribution credit is not administratively feasible at present, but is a possible further future step towards a multi-payer National Health Insurance system, should that be the preferred way forward.

Fairness

Similar to being equitable in terms of aligning tax relief to medical expenditures, policies also need to be fair in terms of taxpayers' ability to pay. In a progressive tax system such as South Africa's, it is important that individuals pay tax according to their income level and means. The same principle should apply for tax relief, and income considerations should play a more important role than other considerations. Fairness can also be applied to rewarding behaviour that is in line with government objectives (eg saving or providing for health insurance).

Affordability and fiscal sustainability

Annexure C indicates that tax revenue foregone associated with medical expense deductions amounted to about R15.7 billion in 2008/09, mainly in respect of the capped deductibility of contributions to medical schemes. The South African personal income tax yielded about R195 billion in revenue in 2008/09. The tax benefit was equivalent to about 6.7 per cent of PIT revenue, and about 12 per cent of estimated total private health expenditure. It needs to be

considered whether this scale of relief is equitable and proportional relative to other pressing obligations of the fiscus.

It also needs to be considered that healthcare spend as proportion to disposable income has been increasing, and all indications are that this trend will continue. Extending or even expanding on the current tax relief afforded to taxpayers may not be affordable going forward, and a balance will have to be found between assisting individuals with medical expenditures, without causing distortions to the overall fiscal resource allocation.

Administrative simplicity

Tax policies should be designed to collect revenue in a manner that is timely and convenient to taxpayers, as well as simple to understand. In line with this, tax relief mechanisms also need to be clear to taxpayers, since simplicity and clarity lead to better tax compliance, and fewer tax disputes. It also leaves less room for abuse and avoidance.

From an administrative point of view, the South African Revenue Service (SARS), as well as employers, would prefer a tax system that is easy to manage and comply with. A complex policy puts strain on information systems and administrative capacity, leading to cost escalations and errors. Administering a hybrid system (between deductions and credits) may cause some of the problems noted above, and may not be a sustainable solution in the long run.

PROPOSALS

In light of the objectives outlined above, a movement from a system of medical deductions to one of medical tax credits is proposed.

First Public Consultation for 2011 TLAB Proposal for implementation in 2012: Tax relief for medical scheme contributions

This proposal discussed below is for implementation in 2012, and is incorporated in the 2011 TLAB.

In the absence of a comprehensive National Health Insurance arrangement, which is being phased in over several years, medical scheme membership is in effect a “merit good”, through which households pre-fund a substantial share of their medical expenditure. In so doing households pool risks with other households and gain access to networks of health care providers under terms that are to some degree negotiated or overseen on their behalf by health funding organisations and their administrators. Medical scheme (or insurance) contributions also assists in relieving the public health system of part of the burden of the cost of health services, in respect of those who can afford such coverage.

South Africa’s Medical Schemes Act and the regulatory oversight of the Medical Schemes Council provide protection to medical scheme members through governance and prudential standards, prescribed minimum benefits and effective prohibition of “risk-rating” or discrimination between members on the basis of age or health status.

The outcome of these provisions is that there is considerable cross-subsidisation within medical schemes, between younger and healthier contributors and the elderly and unwell. Drawing on South African Medical Scheme Council data, Annexure E illustrates that the average claims cost related to prescribed minimum benefits is about three times higher for those aged 65 and higher,

than for medical scheme beneficiaries below 65. Fiscal encouragement of medical scheme membership gives practical effect to the social solidarity benefit of this cross-subsidisation.

Without fiscal inducement, or mandatory membership, participation in medical scheme risk-pooling by the young and healthy would be less than optimal. This results in part from short-sighted behaviour, or a tendency to under-estimate health risks and associated costs, but also from the exercise of choice among benefit options and timing of medical scheme membership, taking into account self-knowledge of health and lifestyle risks. Favourable tax treatment of medical scheme contributions provides a convenient way of encouraging medical scheme membership and offsetting under-insurance, under circumstances where mandatory participation may not be realistic or affordable.

It is proposed that this favourable tax treatment should take the form of a medical scheme contribution tax credit, set at fixed rand amounts per month for members and additional beneficiaries, and adjusted annually for inflation. Taking into account that medical scheme contributions paid by an employer are included as fringe benefits in taxable income, the contribution credit will apply irrespective of whether contributions are paid by the member or his or her employer. As the credit is a fixed amount, the contribution tax credit rate, as a percentage of the member's contribution, will be higher for lower-cost medical scheme options. This arrangement avoids any distorting impact on the marginal cost to consumers of medical scheme membership.

The proposed medical scheme contribution tax credit is R216 a month each for the member (taxpayer) and first dependant, and R144 a month (two-thirds of the member credit) for each additional dependant (in 2011/12 prices). This is broadly equivalent to the present medical scheme contribution deduction for taxpayers in the 30 per cent marginal tax rate bracket (taxable income of R235 001 – R325 000 in 2011/12) and more favourable for lower-income taxpayers. It is somewhat less favourable for taxpayers in higher income brackets (35%, 38% and 40% marginal tax rates).

Importantly, these amounts will reduce a taxpayer's *tax liability*, not taxable income as is the case for deductions. Table 2 illustrates the monthly and annual medical scheme contribution credit for a family of four.

Table 2: Proposed medical scheme contribution credits *(2011/12 values)*

	Taxpayer + Dependants	**Medical Scheme Tax Credit**	
		per month	per annum
Medical scheme contributions	1	216	2592
	2	216	2592
	3	144	1728
	4	144	1728
		720	**8640**

Table 3 compares the impact of the medical scheme contribution tax credit for a family of four, with the present capped deduction allowance, at different income levels. It is clear from Table 3 that a deduction reduces a taxpayer's taxable income, while a tax credit reduces the taxpayer's tax liability.

Table 3: Medical scheme capped deduction vs tax credit *(2011/12 values)*

Taxpayer (under age 65)	A	B	C
Marginal tax rate	18%	30%	40%
Taxable income – before medical deduction (TI 1)	**150,000**	**320,000**	**640,000**
Tax liability on TI 1	***16,245***	***62,895***	***181,495***
Effective tax rate (Tax as % of TI 1)	*10.8%*	*19.7%*	*28.4%*
Medical scheme contribution capped allowance			
Taxpayer plus 3 dependants (R720 x 2 plus R440 x 2 p month)	27,840	27,840	27,840
Taxable income – after medical scheme deduction (TI 2)	**122,160**	**292,160**	**612,160**
Tax liability on TI 2	***11,234***	***54,649***	***170,359***
Effective tax rate (Tax as % of TI 1)	*7.5%*	*17.1%*	*26.6%*
Tax benefit of medical scheme deduction	**5,011**	**8,352**	**11,136**
Reduction in effective tax rate	*3.3%*	*2.6%*	*1.7%*
Medical scheme tax credit (fixed amounts)			
Taxpayer plus 3 dependants (R216 x 2 plus R144 x 2 p month)	8,640	8,640	8,640
Tax liability on TI 1 – after medical scheme tax credit	***7,605***	***54,255***	***172,855***
Effective tax rate (Tax as % of TI 1)	*5.1%*	*17.0%*	*27.0%*
Tax benefit of medical tax credit	**8,640**	**8,640**	**8,640**
Reduction in effective tax rate	*5.8%*	*2.7%*	*1.4%*
Effect of tax credit vs tax deduction	**3,629**	**288**	**-2,496**

Treasury estimates indicate that a contribution tax credit equivalent to about 22 per cent of the current capped amounts would have a similar overall cost to the fiscus as the present deduction, so that in aggregate, and for the majority of taxpayers, the proposed tax credit will bring greater tax relief than the present arrangement.

For fiscal cost and administrative reasons, the proposed medical scheme contribution credit will be non-refundable. It is recognised that there is merit in the case for a refundable arrangement, as this would benefit income-earners at or below the tax threshold and would thus further promote access to medical scheme membership. However, this is not envisaged at this stage. There is also merit in the "tax credit at source" arrangement followed in the Republic of Ireland, which provides for a direct flow of funds from revenue to the medical scheme and thereby a discounted premium collected from the member or employer. The administrative platform envisaged for the intended Medical Schemes Risk Equalisation Fund may prove to be a practical vehicle for implementing this arrangement in South Africa. These options warrant further exploration.

The 2011 TLAB expands on the benefit of a tax credit by proposing that a new non-refundable supplementary medical scheme contribution credit should be introduced, comprising R216 a month for medical scheme members (taxpayers) or dependants who are aged 65 and older, and for a medical scheme member or beneficiary who has a disability, as defined in terms of the Income Tax Act. This supplementary credit benefit will be limited to one credit per person, with no double claim for persons who are aged 65 or above and have a disability. This credit will be also be available to a taxpayer (who may be under 65 and with no disability) whose medical scheme dependants include a person or persons aged 65 and above or with a disability, subject to appropriate administrative controls. It will assist elderly taxpayers to remain in medical scheme membership after retirement, while also reducing the cost to taxpayers as medical scheme beneficiaries. This proposal is intended to take effect on 1 March 2012.

The medical scheme contribution and supplementary credits will be adjusted for inflation annually and taxpayers will be eligible for the medical scheme tax credit if they belong to a qualifying medical scheme. Additional medical scheme contributions in excess of four times the primary medical scheme credit, will be deductible in addition to out of pocket deductions.

Public comment is invited for this proposal as part of the public comment for the Draft 2011 Taxation Laws Amendment Bill, particularly on the shift towards a credit system, as well as the thresholds used like the R216 limit for the two adults and R144 for a maximum of two dependents, as well as the R216 limit for the supplementary medical scheme contribution credit. The deadline for comments on this proposal is extended to 22 July 2011.

Second public consultation process for future proposals: The Tax Treatment of Out-of-Pocket Medical Expenditures

The National Treasury is also seeking a second round of public comments on how to shift from the current system of dealing with catastrophic and out-of-pocket medical expenses towards a credit system, and how and when to effect this change.. Under consideration is whether to shift to a pure credit system for all types of medical expenditure over and above medical scheme contributions. As noted above, these deductions currently vary for those 65 years and older, and for those with a disability, compared to those under 65 years. In seeking public comments, the National Treasury provides possible options to facilitate consultations. Comments should be submitted to the National Treasury by 31 October 2011, which the National Tresaury will take into account when making further proposals in the next or future budgets.

Medical schemes and National Health Insurance arrangements are by design intended to protect individuals and households against unexpectedly high costs associated with health risks. However, even comprehensive medical benefit packages cannot provide complete protection against all possible medical contingencies. In the event of serious injury or illness, households can find themselves confronted with substantial medical expenditure or co-payments over and above their medical scheme benefits. For both those without insurance, and for taxpayers whose medical scheme membership does not fully cover necessary medical expenditure, there is a need for tax relief in the event of large medical outlays that cannot be met from disposable income without hardship.

The current deduction system is meant to provide tax relief for households forced to spend significantly for catastrophic medical expenses, to the extent that such expenditure exceeds 7.5 per cent of taxable income. The 7.5% limit does not apply to those 65 years and over, and for those with disabilities.

Preserving the current system for out-of pocket medical expenses will not only introduce inconsistencies but will mean that SARS will have to then administer a hybrid system involving both credits and deductions for medical expenditure. For this and other reasons, this hybrid system is not preferred by the National Treasury. Given the shift to credits envisaged for medical scheme contributions, the question arises as to why all other deductions should also not be converted into appropriate credits. Instead, the National Treasury believes that the question is rather how best and when to implement the shift to a full credit system – in doing so, National Treasury seeks to implement a fair but also sustainable system, which will take the interests and concerns of vulnerable groups into account.

The second consideration is to ensure that the credit system is more equitable. Under the current system, the unlimited medical deduction for those over 65 years or older, or for those with a disability, would also apply to high income persons. The question arises from an equity and affordability (for the fiscus) perspective, as to whether the medical expenditure claims should not be capped for all high income individuals.

In addition, the current system is more beneficial towards those contributing towards medical schemes. The future proposals maintain this approach, as one of the policy aims is to make it more affordable for people across income groups to contribute to medical schemes. If individuals that can afford it belong to medical schemes, then they will not become dependent on the state when they are in need of costly medical care. This reduces pressure on the public healthcare system, better enabling the system to assist those below the income tax threshold. This approach will also strengthen the shift towards the National Health Insurance, as it lays the foundation for the tax system to support such a policy shift.

In order to facilitate public comment, the following options are presented. They are illustrative of the different ways that the credit system can be implemented or phased in. The options also differentiate between firstly those under 65 years (one option B), and those 65 years and older (two options D and E). People with disability are also covered by the options applying to those 65 years and older. Though the thresholds used are for illustrative purposes, the National Treasury is of the view that a fiscal contribution of 25% of costs above an agreed income threshold, is a reasonable and appropriate level of assistance, and affordable from the perspective of the fiscus.

ILLUSTRATIVE OPTION FOR PERSONS UNDER 65 YEARS

As noted above, the deductions for persons under 65 years takes the form of a deduction allowance in respect of qualifying medical expenses in excess of 7.5 per cent of taxable income. One illustrative option is presented (option B), which should be compared with Option A which reflects the current position.

	Option A	**Option B**
Method of Relief	Tax Deduction	Tax Credit
Conversion Rate	Marginal Rate	25 %
Threshold or Not	Yes	Yes
Threshold %	7.5% of taxable income	10 % of taxable income

Option A : The current deductions system for persons below 65 years

- The current system limits the extent to which individuals can claim out of pocket expenditure.
- The current system is affordable and fiscally sustainable for now, but still costs the fiscus R15.7 billion (2008/2009). Since it does encourage medical scheme membership, pressure on the public healthcare budget is reduced.
- SARS will be expected to administer a dual system of both tax credits and deductions.

Option B: Replace the current tax deduction system with a tax credit system for persons below 65 years

In this option the current deduction system is replaced with a non-refundable medical expenses tax credit for qualifying out-of-pocket medical expenditure incurred during the year of assessment, together with medical scheme contributions in excess of (say) four times the medical scheme contribution tax credit. This credit will be allowed to the extent that the aggregate of such expenditure exceeds (for example) 10 per cent of taxable income. The credit is calculated as 25 per cent of such excess expenditure.

- This is by design a redistributive tax measure, in that for the same quantum of medical expenses in a year of assessment, the medical expenses tax credit declines as a percentage of taxable income with rising income.

- A somewhat higher threshold relative to taxable income than in the present deduction arrangement is proposed for three reasons. Administrative and compliance simplicity, firstly, argues for a higher threshold. Account is taken, secondly, of the steadily rising share of health expenditure in household consumption, making fiscal relief more sustainable only at a higher level of medical expenditure.
- Thirdly, account is taken of the enhanced relief for the majority of taxpayers in the proposed medical scheme contribution credit. On affordability grounds, it is proposed that this should be offset by somewhat higher thresholds for catastrophic expenditure relief.

Table 4 illustrates the impact of the proposed medical expenses tax credit (Option B), by comparison with the present qualifying medical expense deduction (Option A). It clearly illustrates the redistributive effect of medical tax credits, with lower income taxpayers in the 18 per cent bracket being significantly better off. Conversely, taxpayers in the 30 and 40 per cent tax bracket will benefit less under medical tax credits. In the example, a conversion rate of 25 per cent is used. If a higher rate (such as the 30 per cent used for medical scheme contributions) is used, the impact on the higher income groups would be less pronounced, while those in the lower income brackets would benefit even more.

Table 4: Medical expenses deduction vs tax credit *(2011/12 values)*

Taxpayer (under age 65)	No medical scheme			Medical scheme member + 3 dependants		
Marginal tax rate	18%	30%	40%	18%	30%	40%
Taxable income – before medical deduction (TI 1)	150,000	320,000	640,000	150,000	320,000	640,000
Medical scheme contribution capped allowance				27,840	27,840	27,840
Taxable income – after medical scheme deduction (TI 2)				122,160	292,160	612,160
Tax liability	*16,245*	*82,995*	*181,495*	*11,234*	*54,648*	*170,359*
Effective tax rate (Tax as % of TI 1)	*10.8%*	*19.7%*	*28.4%*	*7.5%*	*17.1%*	*26.6%*
Excess contribution				0	16,000	20,000
Out-of-pocket expenses	30,000	40,000	60,000	20,000	30,000	40,000
7.5% of taxable income (TI 1) threshold	11,250	24,000	48,000	11,250	24,000	48,000
Additional deduction allowed	18,750	16,000	12,000	8,750	16,000	12,000
Taxable income – after additional deduction allowed (TI 3)	131,250	304,000	628,000	113,410	276,160	600,160
Tax liability on TI 3	*12,870*	*80,195*	*176,695*	*9,459*	*48,048*	*165,559*
Effective tax rate (Tax as % of TI 1)	8.6%	18.2%	27.6%	6.4%	15.6%	25.9%
Tax benefit of additional deduction	1,375	4,800	4,800	1,575	4,800	4,800
Reduction in effective tax rate	*1.3%*	*1.5%*	*0.8%*	*1.1%*	*1.5%*	*0.8%*
Medical scheme contribution tax credit (fixed amounts)				6,660	6,660	6,660
Tax liability after medical scheme contribution tax credit				*7,605*	*54,335*	*172,855*
Effective tax rate (Tax as % of TI 1)				5.1%	17.0%	27.0%
Excess contribution (above 4 times medscheme credit)				0	3,280	13,280
Out-of-pocket expenses	30,000	40,000	60,000	20,000	30,000	40,000
10% of taxable income (TI 1) threshold	15,000	32,000	64,000	15,000	32,000	64,000
Medical expenses tax credit (25% of above threshold expenses)	3,750	2,000	0	1,250	320	0
Tax liability – after medical expenses tax credit	*12,495*	*80,995*	*181,495*	*8,355*	*54,035*	*172,855*
Effective tax rate (Tax as % of TI 1)	*8.3%*	*16.1%*	*28.4%*	*4.1%*	*16.6%*	*27.0%*
Tax benefit of medical expenses tax credit	3,750	2,000	0	1,250	320	0
Reduction in effective tax rate	2.5%	0.6%	0.0%	0.8%	0.1%	0.0%
Effect of tax credits vs tax deductions	*375*	*-2,800*	*-4,800*	*3,304*	*-4,192*	*-7,296*

THREE ILLUSTRATIVE OPTIONS FOR PERSONS 65 YEARS AND OLDER OR WITH A DISABILITY

Tax relief for medical expenditure incurred by those aged 65 and over takes into account both that health risks rise in old age, and that the elderly typically rely on limited income. It is also recognised that, outside of the public service, employer-sponsorship of medical scheme membership after retirement is in decline. There are self-evident financial sustainability difficulties with post-retirement medical scheme contributions as an employment benefit, and so alternative arrangements need to be sought. Similarly, persons with disabilities are recognised as having higher than average medical expenditures, and therefore also enjoy more generous tax deductions. These principles need to be maintained with any proposed policy options.

As noted above, a balance needs to be sought between assisting these vulnerable groups, while also taking into account the principle of fairness in terms of ability to pay. Currently even high income individuals benefit from the generous tax relief related to out of pocket medical expenditure. In effect, this group is cross subsidised by individuals below the age of 65 years, including those of lesser means. Consideration needs to be given about the sustainability of such a policy, also from an affordability point of view. In moving towards a more equitable medical credit system, with a new supplementary medical scheme contribution credit for persons 65 years and older, former employer contributions to medical scheme membership should also be taken into account when determining the taxable income of retired persons. Vulnerability should also be linked more to limited incomes, especially as the introduction of the supplementary medical scheme contribution credit will significantly improve the affordability of medical scheme membership, which provides risk protection and hence reduces vulnerability. The announced shift to a national health insurance system (once fully implemented) will be a far more powerful vehicle for reducing vulnerability.

A key focus on the shift to a credit system for persons aged 65 years and older, and for persons with a disability, is on how the thresholds used in the illustrative options will affect vulnerable groups. Two policy options (D and E) are presented below, and should be compared with Option C which reflects the current position.

	Option C	**Option D**	**Option E**
Method of Relief	Tax Deduction	Tax Credit	Tax Credit
Conversion Rate	Marginal Rate	25%	25%
Threshold or Not	No	Yes	Yes
Threshold %	NA	Zero	5%

Option C: The current tax deduction system for persons 65 years and older or with a disability

A taxpayer aged 65 or above and those with disabilities can currently claim all contributions to a medical scheme and out-of-pocket medical expenditure as a deduction, without reference either to the capped amounts or the 7.5 per cent of income threshold. Expenditure related to a spouse or dependants included in a medical scheme may be included, irrespective of the age of such

dependants. In addition, medical scheme contributions by a former employer on behalf of retired persons are also excluded from taxable income of the beneficiary.

While there are benefits to the current system, there are some challenges and difficulties. As noted, currently there is no deductions threshold for persons over the age of 65 or for those with disabilities in terms of claiming out of pocket medical expenses; given that additional tax relief is provided through the supplementary credit, the fairness and affordability of having an unlimited out of pocket claims dispensation needs to be considered, particularly for high-income beneficiaries. Further, the above arrangement will require a hybrid administrative system, where SARS will be expected to administer both a credit and deductions system for different categories of persons. This option is evaluated in the table below:

Option D: Convert the current deduction system into a tax credit system, and introduce a zero per cent threshold, for persons 65 years and older or with a disability.

While basically similar to the status quo, the crucial difference is the fixed amount of relief that a tax credit will provide, as opposed to the marginal relief currently afforded. The rate at which it is set, will determine its redistributive impact from higher to lower tax brackets. Table 5 uses a 25 per cent medical expenses tax credit rate as an example. The pros and cons of this option are as follows:

- Eliminates the dual system administrative problem.
- Is negative from a fiscal sustainability point of view.
- Does not affect this group of taxpayers too adversely, and in effect maintains the status quo in terms of their tax status.
- It is however not necessarily fair towards younger taxpayers, who are subsidising older taxpayers, including affluent persons.

Option E: For persons 65 years and older, or with a disability, convert the current deduction system into a tax credit system, and introduce a threshold which limits out of pocket medical expenses claims to the extent that they exceed (as an example) 5 per cent of an individual's taxable income.

The aim of this policy option is to try and address two issues mentioned before, namely fairness and fiscal sustainability. The current system whereby there is unlimited tax relief for out-of-pocket medical expenses for those aged 65 years and above, and those with disabilities, is not fair towards lower income individuals who do not fall into those categories, and are subjected to an income threshold. Also, unlimited tax relief is costly to the fiscus, and can cause perverse incentives whereby medical providers may be incentivised to charge excessive rates for medical procedures, or perform procedures that are not really necessary. Currently all these expenses are deductible from tax.

A minimum expense threshold, similar to that currently in place for those under 65 years of age, may limit these costs. It may also be more fair in terms of the ability to pay principle. However, a threshold for this group will also have disadvantages.

It will affect people over the age of 65 years, as well as those with disabilities quite negatively across all income groups if they don't belong to a medical aid. It will also affect those on medical schemes negatively if they earn over R 200 000 per year, which seems low. These estimates are based on a 5 per cent threshold, and are presented in Tables 5 and 6. A fair balance between the different sometimes conflicting policy objectives could perhaps be achieved through the phasing in of lower thresholds.

The pros and cons of this option are as follows:

- Eliminates the dual system administrative problem.
- Is positive from a fiscal sustainability point of view, and will offset the costs associated with the introduction of the supplementary tax credit.
- Will negatively affect high income taxpayers – for example, if set at 5 per cent of taxable income, the Table below indicates that taxpayers earning R 200 000 or more will be negatively affected. The R200 000 limit is low, but could be increased by lowering the 5 per cent rate.

COMPARING THE THREE CREDIT OPTIONS WITH THE CURRENT DEDUCTION SYSTEM

Table 5 allows for a comparison of the proposed medical credit system and compare it to the current system of deductions, illustrated in Table 6. The illustration includes a 5 per cent taxable income threshold for the medical expenses credit for those aged 65 and above and those with a disability as an example.

Table 5: Proposed medical tax credits – illustrative examples *(2011/12 values)*

	1	2	3	4	5	6	7	8	9	10
	No Medical Scheme		*Medical Scheme Contributor < age 65 (Member + 3 dependants)*					*Aged 65+ or Disability (taxpayer + 3 dependants)*		
Taxable Income (TI)	**150 000**	**150 000**	**150 000**	**300 000**	**300 000**	**600 000**	**600 000**	**150 000**	**300 000**	**600 000**
Marginal tax rate	18%	18%	18%	30%	30%	40%	40%	18%	30%	40%
Medical scheme contribution	-	-	23 000	40 000	40 000	56 000	56 000	-	40 000	56 000
Out-of-pocket qualifying expenses	16 000	30 000	8 000	8 000	30 000	10 000	50 000	24 000	20 000	40 000
Total medical expenditure	16 000	30 000	31 000	48 000	70 000	66 000	106 000	24 000	60 000	96 000
Medical scheme contribution credit (A)	-	-	8 640	8 640	8 640	8 640	8 640	-	8 640	8 640
Excess contribution (over 4 x contribution credit) plus out-of pocket expenses	16 000	30 000	8 000	13 440	35 440	31 440	71 440	24 000	25 440	61 440
Excess expenses threshold	15 000	15 000	15 000	30 000	30 000	60 000	60 000	7 500	15 000	30 000
Percentage of Taxable Income	10%	10%	10%	10%	10%	10%	10%	5%	5%	5%
Excess expenses above threshold	1 000	15 000	0	0	5 440	0	11 440	16 500	10 440	31 440
Medical expenses credit (25%) (B)	250	3 750	0	0	1 360	0	2 860	4 125	2 610	7 860
Supplementary medical scheme credit (C)								-	2 592	2 592
Tax credit relief (A+B+C)	**250**	**3 750**	**8 640**	**8 640**	**10 000**	**8 640**	**11 500**	**4 125**	**13 842**	**19 092**
% of Taxable income	0.2%	2.5%	5.8%	2.9%	3.3%	1.4%	1.9%	2.8%	4.6%	3.2%
% of Total medical expenditure	1.6%	12.5%	27.9%	18.0%	14.3%	13.1%	10.8%	17.2%	23.1%	19.9%

It is clear from the above that the issues relating to the tax treatment medical expenses for those 65 years and older, as well as those with disabilities, are complex, and need to be further investigated before proceeding with any new options. For this reason, further consultations will take place with organisations representing the interests of the aged and those will disabilities before making further proposals. Following this process, and greater details on the implementation of the National Health Insurance, a formal proposal is only expected to be presented in the next or future budgets, and will hence only take effect thereafter, possibly with phasing.

A second round of public comment is invited for the three medical credit options presented above on out-of-pocket medical expenses, including for the thresholds and phase-in periods. A formal proposal will be tabled in the next or following Budget thereafter. These proposals are therefore NOT legislated in the Draft 2011 Taxation Laws Amendment Bill. The deadline for comments is 31 October 2011. National Treasury will also facilitate a workshop with key stakeholders to facilitate the public comment process.

Table 6: Taxpayers aged 65 and above - 5% taxable income threshold

Taxpayer (age 65+)	**No medical scheme**				**65+ Medical scheme member + one 65+ dependant**			
Marginal tax rate	18%	25%	30%	40%	18%	25%	30%	40%
Taxable Income – before medical deduction (TI 1)	**140 000**	**230 000**	**320 000**	**680 000**	**120 000**	**230 000**	**320 000**	**680 000**
Medical scheme contribution capped allowance					17 280	17 280	17 280	17 280
Taxable Income – after medical scheme deduction (TI 2)					**102 720**	**212 720**	**302 720**	**662 720**
Tax liability	***8 433***	***30 233***	***56 983***	***191 483***	***1 723***	***25 913***	***56 983***	***184 571***
Effective tax rate (Tax as % of TI 1)	*6.0%*	*13.1%*	*17.8%*	*28.2%*	*1.4%*	*11.3%*	*17.8%*	*27.1%*
Excess contribution					0	2 000	8 000	20 000
Out-of-pocket expenses	15 000	25 000	40 000	60 000	4 000	10 000	15 000	30 000
Additional deduction allowed	15 000	25 000	40 000	60 000	4 000	12 000	23 000	50 000
Taxable Income – after additional deduction allowed (TI 3)	**125 000**	**205 000**	**280 000**	**620 000**	**98 720**	**200 720**	**279 720**	**612 720**
Tax liability on TI 3	***5 733***	***23 983***	***44 983***	***167 483***	***1 003***	***22 913***	***44 899***	***164 571***
Effective tax rate (Tax as % of TI 1)	4.1%	10.4%	14.1%	24.6%	0.8%	10.0%	14.0%	24.2%
Tax benefit of additional deduction	**2 700**	**6 250**	**12 000**	**24 000**	**720**	**3 000**	**12 084**	**20 000**
Reduction in effective tax rate	*1.9%*	*2.7%*	*3.8%*	*3.5%*	*0.6%*	*1.3%*	*3.8%*	*2.9%*
Medical scheme contribution tax credit (fixed amounts)					5 184	5 184	5 184	5 184
Supplementary medical scheme contribution tax credit					5 184	5 184	5 184	5 184
Tax liability after medical scheme (incl. supp cr.) contrib tax credit					***0***	***19 865***	***46 615***	***181 115***
Effective tax rate (Tax as % of TI 1)					*0.0%*	*8.6%*	*14.6%*	*26.6%*
Excess contribution (above 4 times medscheme credit)					0	0	4 544	16 544
Out-of-pocket expenses	15 000	25 000	40 000	60 000	4 000	10 000	15 000	30 000
5% of taxable income (TI 1) threshold	7 000	11 500	16 000	34 000	6 000	11 500	16 000	34 000
Medical expenses tax credit (25% of above threshold expenses)	2 000	3 375	6 000	6 500	0	0	886	3 136
Tax liability – after medical expenses tax credit	***6 433***	***26 858***	***50 983***	***184 983***	***0***	***19 865***	***45 729***	***177 979***
Effective tax rate (Tax as % of TI 1)	*4.6%*	*11.7%*	*15.9%*	*27.2%*	*0.0%*	*8.6%*	*14.3%*	*26.2%*
Tax benefit of medical expenses tax credit	**2 000**	**3 375**	**6 000**	**6 500**	**0**	**0**	**886**	**3 136**
Reduction in effective tax rate	1.4%	1.5%	1.9%	1.0%	0.0%	0.0%	0.3%	0.5%
Effect of tax credits vs tax deductions	***-700***	***-2 875***	***-6 000***	***-17 500***	***1 003***	***3 048***	***-830***	***-13 408***

7 IMPACT ON THE FISCUS

Annexure C sets out an estimate of the tax cost of medical expense and disability-related deductions for the 2008/09 year. The estimates are based on the reported deductions for the assessed 69 per cent of taxpayers included in the most recent Tax Statistics report. Grossed up to 100 per cent, these estimates indicate a medical tax deduction benefit to 2.65 million individuals of R7.0 billion in 2008/09, and disability-related benefits to 39 700 individuals amounting to R389 million. Medical scheme members also benefit from capped contribution allowances paid by employers, with an estimated tax value of R7.4 billion in 2008/09. Medical scheme contributions by employers on behalf of retirees or dependants of deceased former employees account for a further tax benefit estimated at R896 million, mainly accruing to taxpayers aged 65 and older. This brings the total estimated tax benefit of medical deductions and exempt contributions by employers in 2008/09 to R15.7 billion.

Annexure C also outlines estimates of the tax cost of the proposed tax credit system, calibrated to 2008/09 values. Medical scheme contribution credits would have amounted to R14.5 billion in 2008/09, supplementary disability and age 65 and over credits would have come to R1.1 billion and above threshold medical expense credits are estimated at R2.1 billion, for a total fiscal cost of R16.7 billion.

The distribution of the tax benefit by income group for the deduction and credit systems is summarised in Table 7. An estimated 68.2 per cent of the tax credit benefit goes to taxable income groups below R200 000 a year, compared with 53.4 per cent in the current deductions system.

Table 7: Distribution of tax benefit: Deductions vs Tax Credits 2008/09

Taxable income group[1]	Marginal tax rate	Distribution of Tax Benefit			
		Medical Tax Deductions		Medical Tax Credits	
		(R million)	%	(R million)	%
< 0 - 40000 / 70 000	0%	564	3.6%	946	5.7%
70 000 - 120 000	18%	3 360	21.4%	5 526	33.1%
120 000 - 200 000	25%	4 474	28.4%	4 911	29.4%
200 000 - 300 000	30%	2 758	17.5%	2 351	14.1%
300 000 - 400 000	35%	1 639	10.4%	1 177	7.0%
400 000 - 500 000	38%	945	6.0%	596	3.6%
500 000 +	40%	1 988	12.6%	1 191	7.1%
Total		**15 728**	**100.0%**	**16 698**	**100.0%**

[2] *For Taxable income group <0 - R40 000 (below age 65) / R70 000 (age 65 and over), it is assumed that 50% of the amount allowed represents a cost to fiscus at the 18% rate.*

8 CONCLUSION AND RECOMMENDATIONS

It is proposed that a tax credit system should replace the current medical scheme contribution and medical expense deductions. This will achieve greater equity in the tax treatment of medical expenses across income groups, and is a further step towards a community-wide National Health Insurance system. As National Health Insurance is phased in, the tax arrangements will be reviewed and further changes may be made.

The proposed medical tax credit system will have the following features:

- The current system of medical scheme contribution and medical expense deductions will be converted into medical tax credits, governed by broadly similar qualifying rules.
- A medical scheme contribution credit will be available to taxpayers who belong to a medical scheme, set at a fixed amount per month for the taxpayer and first dependant, and two-thirds of this amount for additional dependants, adjusted annually for inflation. In 2011/12 values, amounts of R216 a month for the taxpayer and first dependant, and R144 a month for additional dependants, are proposed.
- A supplementary medical scheme contribution credit of R216 a month is proposed for members or dependants aged 65 and above, and members or dependants with a disability.

- Additional consultation relating to out-of-pocket medical expenses will be conducted until 31 October 2011, and will be further refined and presented as proposals in the next or future Budgets. The status quo regarding deductions of this nature will be maintained until then. Further, for taxpayers aged 65 years and older and those with disabilities, the out-of-pocket policy changes will be adopted after an appropriate consultative process with representative groups. Until such time, the status quo for this group will be maintained.

- Some illustrative options regarding the tax treatment of out of pocket expenses are presented in this document, and public engagement is sought in order to further refine these.
- Medical tax credits will be non-refundable. Once the proposed medical schemes risk equalisation fund is in place and as a further step in National Health Insurance reform, and subject to practicality and affordability, the possibility of extending the benefit of the medical scheme contribution tax credit to those who fall below the tax threshold or who qualify for credits that exceed their tax liability may be considered.

The medical scheme contribution credit and supplementary tax credits are intended to come into effect on 1 March 2012, subject to the public consultation process and Parliamentary approval. Future proposals specifically related to out of pocket medical expenditure will be implemented after wider consultation.

1 March 2012	The medical scheme contribution credit and supplementary medical scheme tax credit as included in the Tax Laws Amendment Bill of 2011.) Public comments are invited by 22 July 2011.
June-October 2011	Period for consultation on the tax treatment of out of pocket medical expenses. Public comments are invited by 31 October 2011.

ANNEXURE A

Section 18 of the *Income Tax Act No.* 58 *of* 1962 – Deduction in respect of Medical and Dental Expenses

18. Deduction in respect of medical and dental expenses.—(1) Notwithstanding the provisions of section 23, there must be allowed to be deducted from the income of any taxpayer who is a natural person an allowance in respect of—

(a) any contributions made by that taxpayer in respect of the year of assessment in respect of that taxpayer, his or her spouse and any dependant, as defined in section 1 of the Medical Schemes Act, 1998 (Act No. 131 of 1998), of that taxpayer to—

(i) any medical scheme registered under the provisions of that Act; or

(ii) any fund which is registered under any similar provision contained in the laws of any other country where the medical scheme is registered;

(b) any amounts (other than amounts recoverable by the taxpayer or his or her spouse) which were paid by the taxpayer during the year of assessment to any duly registered—

(i) medical practitioner, dentist, optometrist, homeopath, naturopath, osteopath, herbalist, physiotherapist, chiropractor or orthopaedist for professional services rendered or medicines supplied to the taxpayer, his or her spouse or his or her children, or any dependant of the taxpayer if the taxpayer was a member of a scheme or fund contemplated in paragraph (a) and that dependant was, at the time such amounts were paid, admitted as a dependant of the taxpayer in terms of that scheme or fund; or

(ii) nursing home or hospital or any duly registered or enrolled nurse, midwife or nursing assistant (or to any nursing agency in respect of the services of such a nurse, midwife or nursing assistant) in respect of the illness or confinement of the taxpayer, his or her spouse or his or her children, or any dependant of the taxpayer contemplated in subparagraph (i); or

(iii) pharmacist for medicines supplied on the prescription of any person mentioned in subparagraph (i) for the taxpayer, his or her spouse or his or her children, or any dependant of the taxpayer contemplated in subparagraph (i); and

(c) any amounts (other than amounts recoverable by the taxpayer or his or her spouse) which were paid by the taxpayer during the year of assessment in respect of expenditure incurred outside the Republic on services rendered or medicines supplied to the taxpayer or his or her spouse or children, or any dependant of the taxpayer contemplated in paragraph (b) (i), and which are substantially similar to the services and medicines in respect of which a deduction may be made under paragraph (b) of this subsection; and

(d) any expenditure that is prescribed by the Commissioner (other than expenditure recoverable by the taxpayer or his or her spouse) necessarily incurred and paid by the taxpayer in consequence of any physical impairment or disability suffered by the taxpayer, his or her spouse or child, or any dependant of the taxpayer contemplated in paragraph (b) (i).

(2) The allowance under subsection (1) is equal to—

(a) where the taxpayer is entitled to a rebate under section 6 (2) (b)*(ie taxpayers over age 65)*, the sum of the amounts referred to in subsection (1);

(b) where the taxpayer, his or her spouse or child is a person with a disability, the sum of the amounts referred to in subsection (1); or

(c) in any other case—

(i) so much of the contributions made by the taxpayer during the relevant year of assessment as contemplated in subsection (1) (a), as does not exceed—

(aa) R625[9] for each month in that year in respect of which those contributions were made solely with respect to the benefits of that taxpayer;

(bb) R1 250[10] for each month in that year in respect of which those contributions were made with respect to the benefits of that taxpayer and one dependant; or

(cc) where those contributions are made with respect to the taxpayer and more than one dependant, the amount referred to in item (bb) in respect of the taxpayer and one dependant plus R380[11] for every additional dependant for each month in that year in respect of which those contributions were made;

(ii) so much of—

(aa) any contributions contemplated in subsection (1) (a) as have not been allowed as a deduction under subparagraph (i); and

(bb) the sum of all amounts contemplated in subsection (1) (b), (c) and (d),

as in the aggregate exceeds 7,5 per cent of the taxpayer's taxable income (excluding any retirement fund lump sum benefit and retirement fund lump sum withdrawal benefit) as determined before allowing any deduction under this subparagraph.

Seventh Schedule

CONTRIBUTION TO BENEFIT FUND

12A. (1) The cash equivalent of the value of the taxable benefit contemplated in paragraph 2 (*i*) is the amount of any contribution or payment made by the employer in respect of a year of assessment, directly or indirectly, to any medical scheme registered under the Medical Schemes Act, 1998 (Act No. 131 of 1998), or to any fund which is registered under any similar provision contained in the laws of any other country where the medical scheme is registered, for the benefit of any employee or dependants, as defined in that Act, of that employee.

(2) Where any contribution or payment made by an employer contemplated in subparagraph (1) is made in such a manner that an appropriate portion thereof cannot be attributed to the relevant employee or his or her dependants, the amount of that contribution or payment in relation to that employee and his or her dependants is deemed, for purposes of subparagraph (1), to be an

[9] R720 for 2011/12
[10] R1 440 for 2011/12
[11] R440 for 2011/12

amount equal to the total contribution or payment by the employer to the fund during the relevant period for the benefit of all employees and their dependants divided by the number of employees in respect of whom the contribution or payment is made.

(3) If the Commissioner is in any case satisfied that the apportionment of the contribution or payment amongst all employees in accordance with subparagraph (2) does not reasonably represent a fair apportionment of that contribution or payment amongst the employees, he or she may direct that the apportionment be made in such other manner as to him or her appears fair and reasonable.

(4) The exercise by the Commissioner of his discretion contemplated in subparagraph (3) shall be subject to objection and appeal.

(5) No value shall be placed in terms of this paragraph on the taxable benefit derived from an employer by—

(*a*) a person who by reason of superannuation, ill-health or other infirmity retired from the employ of such employer; or

(*b*) thedependants of a person after such person's death, if such person was in the employ of such employer on the date of death; or

(*c*) thedependants of a person after such person's death, if such person retired from the employ of such employer by reason of superannuation, ill-health or other infirmity;

(*d*) a person who during the relevant year of assessment is entitled to a rebate under section 6 (2) (*b*)*(ie taxpayers over age 65)*.

INCURRAL OF COSTS RELATING TO MEDICAL SERVICES

12B. (1) The cash equivalent of the value of the taxable benefit contemplated in paragraph 2 (*j*) is the amount incurred by the employer during any month, directly or indirectly, in respect of any medical, dental and similar services, hospital services, nursing services or medicines in respect of that employee, his or her spouse, child or other relative or dependants.

(2) Where the payment of any amount contemplated in subparagraph (1) is made in such a manner that an appropriate portion thereof cannot be attributed to the relevant employee and his or her spouse, children, relatives and dependants, the amount of that payment in relation to that employee and his or her spouse, children, relatives and dependants is, for purposes of subparagraph (1), deemed to be an amount equal to the total amount incurred by the employer during the relevant period in respect of all medical, dental and similar services, hospital services, nursing services or medicines for the benefit of all employees and their spouses, children, relatives and dependants divided by the number of employees who are entitled to make use of those services.

(3) No value must be placed in terms of this paragraph on any taxable benefit—

(*a*) resulting from the provision of medical treatment listed in any category of the prescribed minimum benefits determined by the Minister of Health in terms of section 67 (1) (*q*) of the Medical Schemes Act, 1998 (Act No. 131 of 1998), which is provided to the employee or his or her spouse or children in terms of a scheme or programme of that employer—

(i) which constitutes the carrying on of the business of a medical scheme if that scheme or programme has been approved by the Registrar of Medical Schemes as being exempt from complying with the requirements of medical schemes in terms of that Act; or

(ii) which does not constitute the carrying on of the business of a medical scheme, if that employee and his or her spouse and children—

(*aa*) are not beneficiaries of a medical scheme registered under the Medical Schemes Act, 1998 (Act No. 131 of 1998); or

(*bb*) are beneficiaries of such a medical scheme, and the total cost of that treatment is recovered from that medical scheme;

(*a*A) where the services are rendered or the medicines are supplied for purposes of complying with any law of the Republic;

(*b*) derived from an employer by—

(i) a person who by reason of superannuation, ill-health or other infirmity retired from the employ of that employer;

(ii) the dependants of a person after that person's death, if that person was in the employ of that employer on the date of death;

(iii) the dependants of a person after that person's death, if that person retired from the employ of that employer by reason of superannuation, ill-health or other infirmity; or

(iv) a person who during the relevant year of assessment is entitled to a rebate under section 6 (2) (*b*); or

(*c*) where the services are rendered by the employer to its employees in general at their place of work for the better performance of their duties.

ANNEXURE B

Section 18 of the Income Tax Act (Summary by SARS)

1. Section 18(1) – Total qualifying expenses

Section	Nature of expenses	Qualifying persons
18(1)(a)	Contributions made by a taxpayer (i.r.o. the year of assessment) to – • any medical scheme registered under the Medical Schemes Act, 1998 (Act No.131 of 1998) (Medical Schemes Act); or • any fund registered under similar provision in any other country.	Contributions must be made in respect of: • taxpayer • taxpayer's spouse • dependant of the taxpayer as defined in section 1 of Medical Schemes Act, 1988 (Act No. 131 of 1998) (i.e. dependent child or other members of the taxpayer's immediate family i.r.o. whom the taxpayer (member) is liable for family care & support or any other person who, under the rules of a medical scheme, is recognised as a dependant of the taxpayer) **"dependant"** means— *(a)* the spouse or partner, dependant children or other members of the member's immediate family in respect of whom the member is liable for family care and support; or *(b)* any other person who, under the rules of a medical scheme, is recognised as a dependant of a member;
18(1)(b)	Non-recoverable amounts paid by the taxpayer any duly registered – • health professionals (incl. a herbalist) for services or medicines supplied; or • nursing home or hospital or any nurse, or midwife or nursing assistant i.r.o. illness; or • pharmacist for medicines prescribed by any duly registered health professional.	The non-recoverable amounts must be paid in respect of: • taxpayer; • taxpayer's spouse • taxpayer's children • taxpayer'sdependant admitted as a dependant of the taxpayer i.r.o. the medical scheme at the time the amount is paid(any other person who, under the rules of a medical scheme, is recognised as a dependant of a member).
18(1)(c)	Non-recoverable amounts paid by the taxpayer outside the Republic for services rendered or medicines supplied	The non-recoverable amounts must be paid in respect of: • taxpayer; • taxpayer's spouse • taxpayer's children • taxpayer'sdependant admitted as a dependant of the taxpayer i.r.o. the medical scheme at the time the amount is paid(any other person who, under the rules of a medical scheme, is recognised as a dependant of a member).
18(1)(d)	Non-recoverable amounts necessarily incurred and paid by the taxpayer in consequence of physical impairment or disability	The non-recoverable physical impairment or disability expenses must be incurred and paid in respect of:

		• taxpayer; • taxpayer's spouse • taxpayer's children • taxpayer'sdependant admitted as a dependant of the taxpayer i.r.o. the medical scheme at the time the amount is paid (any other person who, under the rules of a medical scheme, is recognised as a dependant of a member).

2. Section 18(2) of the Act - Deductions

Section	Full Deduction: total qualifying expenses	Limited deduction
18(2)(a)	Taxpayer is 65 years and older	
18(2)(b)	Taxpayer, his or her spouse or child has a disability **Note:** The disability must first be confirmed by a duly registered medical practitioner in terms of a diagnostic criteria (Form ITR-DD) prescribed by SARS before a full deduction may be allowed. Failure to confirm disability will result in the total qualifying expenses being subjected to a limitation (pls see section 18(2)(c) below). **Note: A**dditional dependants are not included and expenses relating to such people are subject to the limitations.	
18(2)(c)(i)	Taxpayer is under 65 and has no disability	Contributions made by the taxpayer i.r.o section 18(1)(a) as does not exceed capped amounts. Capped Amounts: • R670 per month for each of the first 2 dependants; and • R410 per month for each additional dependant
18(2)(c)(ii)	Taxpayer is under 65 and has no disability	So much of- • employee contributions [18(1)(a)] in excess of the capped amount (i.e. not allowed under 18(2)(c)(i)); and • sum of all expenses qualifying under 18(1)(b);(c) and (d), as in aggregate exceeds 7.5% of the taxpayer's taxable income (excluding retirement fund lump sum benefit and retirement fund lump sum withdrawal benefit) as determined before allowing any deduction under this subparagraph (i.e. as determined after allowing 18(2)(i) deduction).

Note: (section 18(5) of the Act)

For purposes of section 18, any amount contemplated in section 18(1), which has been paid by –

- the estate of a deceased taxpayer is deemed to have been paid by the taxpayer on the day before death;

- an employer of such taxpayer, to the extent that the amount has been included in the income of that taxpayer as a taxable benefit i.r.o. the 7th Schedule, is deemed to have been paid by that taxpayer.

ANNEXURE C

EstimatedTaxBenefit of Medical Deductions and Tax Credits – 2008/09

The benefit to taxpayers of the deductibility of medical scheme contributions and medical expenses, and the corresponding tax revenue foregone, are estimated below for the 2008/09 year.

Table C1 sets out the cost to the fiscus of medical scheme contribution and expense deductions by individual taxpayers in 2008/09. These estimates are based on assessed returns of 69 per cent of taxpayers, as published in the *2010 Tax Statistics*. Grossed up to 100 per cent, the statistics indicate that 2.65 million taxpayers, or 51 per cent of all taxpayers liable for assessment, qualified for medical deductions amounting to R29.2 billion, at a tax cost to the fiscus of just over R7 billion.

Table C2 indicates that an estimated 37 000 taxpayers qualified for medical expense deductions associated with a disability of the taxpayer or a dependant. R1.5 billion was allowed in deductions, at an estimated tax cost of R389 million.

Table C1: Estimated tax cost of individual taxpayers' medical scheme contribution and expense deductions 2008/09

Taxable income group (R per year)	Marginal tax rate	Medical Scheme Contribution and Expense Deductions (69% Assessed) Number of Taxpayers	(69% Assessed) Amount allowed (R million)	(Grossed up to 100%) Number of taxpayers	(Grossed up to 100%) % of Registered Taxpayers	(Grossed up to 100%) Amount allowed (R million)	(Grossed up to 100%) Average allowed (R)	Estimated Cost to Fiscus[1] (R million)
< 0 - 40 000	0%	102 512	2 456	148 568	24.0%	3 559	23 958	320
40 000 - 120 000	18%	548 956	5 846	795 588	51.5%	8 472	10 649	1 525
120 000 - 200 000	25%	594 708	5 369	861 896	57.9%	7 781	9 028	1 945
200 000 - 300 000	30%	279 651	2 915	405 291	56.3%	4 225	10 424	1 267
300 000 - 400 000	35%	129 711	1 415	187 987	56.9%	2 051	10 909	718
400 000 - 500 000	38%	66 474	758	96 339	55.1%	1 099	11 403	417
500 000 +	40%	107 369	1 411	155 607	49.3%	2 045	13 142	818
Total		**1 829 381**	**20 170**	**2 651 277**	**51.0%**	**29 232**	**11 026**	**7 011**

[1] *For taxable income group <0 - R40 000, it is assumed that 50% of the amount allowed represented a cost to fiscus at the 18% rate.*

Table C2: Estimated tax cost of disability allowances for medical scheme contributions and expenses 2008/09

Taxable income group (R per year)	Marginal tax rate	Medical Disability Allowances (69% Assessed) Number of taxpayers	(69% Assessed) Amount allowed (R million)	(Grossed up to 100%) Number of taxpayers	(Grossed up to 100%) % of Registered Taxpayers	(Grossed up to 100%) Amount allowed (R million)	(Grossed up to 100%) Average allowed (R)	Estimated Cost to Fiscus[1] (R million)
< 0 - 40 000	0%	2 365	122	3 428	0.6%	177	51 586	16
40 000 - 120 000	18%	7 890	227	11 435	0.7%	329	28 771	59
120 000 - 200 000	25%	7 054	205	10 223	0.7%	297	29 062	74
200 000 - 300 000	30%	4 037	145	5 851	0.8%	210	35 918	63
300 000 - 400 000	35%	2 160	88	3 130	0.9%	128	40 741	45
400 000 - 500 000	38%	1 269	60	1 839	1.1%	87	47 281	33
500 000 +	40%	2 642	170	3 829	1.2%	246	64 345	99
Total		**27 417**	**1 017**	**39 735**	**0.8%**	**1 474**	**37 094**	**389**

[1] *For taxable income group <0 - R40 000, it is assumed that 50% of the amount allowed represented a cost to fiscus at the 18% rate.*

These allowances take into account medical scheme contributions and medical expenses paid out-of-pocket by the taxpayer, and medical scheme contributions paid by employers in excess of the allowed capped medical contribution amounts of R570 a month for medical scheme members and the first dependant, and R345 a month for additional dependants. Allowed deductions also include medical scheme contributions in excess of the capped amounts and out-of-pocket expenditure, which exceed 7.5 per cent of taxable income in respect of taxpayers under the age of 65. Taxpayers aged 65 and older, and taxpayers with a disability or a dependant with a disability, are not subject to the 7.5 per cent threshold.

The tax benefit associated with medical scheme contributions and qualifying expenses paid by employers or former employers needs to be added to these estimates. The published tax statistics do not include this data, but an estimate can be made based on medical scheme data and reasonable assumptions about the share of medical scheme contributions paid by employers.

Table C3: Estimated tax cost of capped medical scheme contributions by employers on behalf of employees 2008/09

Taxable income group (R per year)	Marginal tax rate	Principal Members		Average Capped Deduction[1] (R)	Total Capped Deduction (R million)	Estimated Employer Contribution (50%)	Estimated Cost to Fiscus[2] (R million)
		Estimated Distribution	Number				
Principal members employed and below age 65							
< 0 - 40 000	0%	7%	212 450	12 000	2 549	1 785	161
40 000 - 120 000	18%	31%	940 850	13 000	12 231	8 562	1 541
120 000 - 200 000	25%	30%	910 500	14 000	12 747	8 923	2 231
200 000 - 300 000	30%	14%	424 900	14 500	6 161	4 313	1 294
300 000 - 400 000	35%	7%	212 450	15 000	3 187	2 231	781
400 000 - 500 000	38%	3.5%	106 225	15 500	1 646	1 153	438
500 000 +	40%	7.5%	227 625	15 500	3 528	2 470	988
Total		**100%**	**3 035 000**	**13 855**	**42 050**	**29 435**	**7 433**

[1] *Assuming 31% single members, 29% member plus one, 19% member plus two, 21% member plus three or more dependants.*

[2] *For taxable income group <0 - R40 000, it is assumed that 50% of the amount allowed represented a cost to fiscus at the 18% rate.*

Table C4: Estimated tax cost of medical scheme contributions by employers on behalf of retirees and dependants of former employees[1] 2008/09

Taxable income group (R per year)	Marginal tax rate	Principal Members		Average scheme Contribution (R)	Total scheme Contribution (R million)	Estimated Employer Contribution (60%)	Estimated Cost to Fiscus[2] (R million)
		Estimated Distribution	Number				
Principal members retired from employment and/or aged 65 and over							
< 0 - 70 000	0%	25%	88 750	12 000	1 065	746	67
70 000 - 120 000	18%	35%	124 250	15 000	1 864	1 305	235
120 000 - 200 000	25%	20%	71 000	18 000	1 278	895	224
200 000 - 300 000	30%	9%	31 950	20 000	639	447	134
300 000 - 400 000	35%	5%	17 750	22 000	391	273	96
400 000 - 500 000	38%	2.5%	8 875	24 000	213	149	57
500 000 +	40%	3.5%	12 425	24 000	298	209	83
Total		**100%**	**355 000**	**16 190**	**5 747**	**4 023**	**896**

[1] *Medical scheme contributions and expenses paid on behalf of retired former employees or dependants of former employees, excluded from taxable income in terms of Schedule 7 of the Income Tax Act.*

[2] *For taxable income group <0 - R70 000, it is assumed that 50% of the amount allowed represented a cost to fiscus at the 18% rate.*

Table C3 outlines an estimate of the tax benefit of medical scheme contributions paid by employers, on the assumption that on average,70 per cent of capped deduction allowances are paid by employers. These estimates take into account medical scheme data which indicate that on average there are 1.3 dependants for every principal member.

Table C4 provides an estimate of the tax benefit of post-retirement medical scheme contributions paid by former employers, and contributions in respect of dependants of former employees, which are not subject to capped allowances. Medical scheme data indicate that approximately 6.2per cent ofbeneficiaries are pensioners. These estimates allow for 355 000 member pensioners, and a further 130 000 dependants over the age of 65. It is assumed that employers and former employers account for 70 per cent of the medical scheme contribution.

Table C5: Estimated total tax cost of medical scheme contributions and expense deductions 2008/09

Taxable income group	Marginal tax rate	Number of Taxpayers	Principal Medical Scheme Members	Employer Contributions		Taxpayer Deductions			Total	Estimated Cost to Fiscus[2]
				Capped Allowance	Post-retirement Assistance	Capped Allowance	Above threshold Expenses[1]	Disability or Disabled Dependant		
(R per year)				(R million)		(R million)			(R million)	(R million)
< 0 - 40000 / 70 000	0%	618 826	301 200	1 785	746	765	2 795	177	6 266	564
70 000 - 120 000	18%	1 545 484	1 065 100	8 562	1 305	3 669	4 803	329	18 668	3 360
120 000 - 200 000	25%	1 489 454	981 500	8 923	895	3 824	3 957	297	17 896	4 474
200 000 - 300 000	30%	719 993	456 850	4 313	447	1 848	2 376	210	9 195	2 758
300 000 - 400 000	35%	330 377	230 200	2 231	273	956	1 095	128	4 682	1 639
400 000 - 500 000	38%	174 936	115 100	1 153	149	494	605	87	2 487	945
500 000 +	40%	315 920	240 050	2 470	209	1 058	986	246	4 970	1 988
Total		**5 194 990**	**3 390 000**	**29 435**	**4 023**	**12 615**	**16 617**	**1 474**	**64 164**	**15 728**

[1] *Above 7.5% of taxable income for taxpayers below age 65; all qualifying medical expenses for taxpayers over 65.*

[2] *For Taxable income group <0 - R40 000 (below age 65) / R70 000 (age 65 and over), it is assumed that 50% of the amount allowed represented a cost to fiscus at the 18% rate.*

Table C5 summarises the estimated total tax cost of medical scheme contributions and medical expense deductions in 2008/09. Tax-exempt employer contributions amount to R33.5 billion, of which capped allowances are estimated at R29.4 billion and post retirement contribution assistance amounts to R4.0 billion. Taxpayers' deductions include the balance of capped medical scheme contribution allowances, above threshold expenses amounting to an estimated R16.6 billion and disability-related expenses of R1.5 billion. Exempt employer contributions together with taxpayer deductions amount to an estimated R64.2 billion, and account for R15.7 billion in medical scheme contribution and expense tax benefits.

Approximately R14 billion of this is accounted for by taxpayers who are medical scheme contributors, which represents an average tax benefit to medical scheme members of R4 130 a year, or R1 780 per medical scheme beneficiary. Approximately R12 billion of the total tax cost is attributable to medical scheme contribution allowances, and R3.7 billion to out-of-pocket expenses.

These estimates are consistent with available tax statistics and medical scheme data reported by the Medical Schemes Council. However, the underlying data are incomplete, and the results are therefore sensitive to several key assumptions. A critical variable is the balance between employer and employee-paid medical scheme contributions. If the share of capped allowances paid by employers is 60 per cent, rather than 70 per cent, then the estimated total tax cost falls from R15.7 billion to R14.3 billion. Recent revisions to the relevant tax provisions will allow more accurate analysis to be undertaken in future.

Adaptations to this analysis allow a comparable tax cost of the proposed tax credit system to be estimated for the 2008/09 year. This is set out in table C6. The assumed tax credits are R170 a month for a medical scheme member and the first dependant, and R110 a month for additional

dependants, equivalent in real terms to the proposed credit values for 2011/12. The proposed credit system would have had a tax cost of R16.7 billion in 2008/09, or approximately R1.0 billion more than the medical deduction regime.

Table C6: Estimated tax cost of medical credit system 2008/09

Taxable income group	Marginal tax rate	Medical Scheme Beneficiaries					Medical scheme Contribution Credit	Supple-mentary Credit	Medical Expenses Credit[1]	Estimated Cost to Fiscus[2]
		Principal Member	First Dependant	Additional Dependant	Disability	Over Age 65				
Credit value per annum		***2 040***	***2 040***	***1 320***	***2 040***	***2 040***	(R million)			(R million)
< 0 - 40000 / 70 000	0%	301 200	207 828	190 390	2 365	122 050	1 290	254	349	946
70 000 - 120 000	18%	1 065 100	734 919	673 256	7 890	170 870	4 561	365	600	5 526
120 000 - 200 000	25%	981 500	677 235	620 412	7 054	97 640	4 203	214	495	4 911
200 000 - 300 000	30%	456 850	315 227	288 777	4 037	43 938	1 956	98	297	2 351
300 000 - 400 000	35%	230 200	158 838	145 511	2 160	24 410	986	54	137	1 177
400 000 - 500 000	38%	115 100	79 419	72 755	1 269	12 205	493	27	76	596
500 000 +	40%	240 050	165 635	151 737	2 642	17 087	1 028	40	123	1 191
Total		**3 390 000**	**2 339 100**	**2 142 838**	**27 417**	**488 200**	**14 516**	**1 052**	**2 077**	**16 698**

[1] *Estimated at 0.25 (credit rate) x 50% of the Above Threshold Expenses in the current deductions regime (taking into account higher threshold levels).*

[2] *For Taxable income group <0 - R40 000 (below age 65) / R70 000 (age 65 and over), it is assumed that 50% of the potential credit total represents a cost to the fiscus.*

The distribution of tax deduction and tax credit benefits between income groups is summarised in table C7. An estimated 68.2 per cent of the tax credit benefit goes to the taxable income groups below R200 000 a year, compared with 53.4 per cent in the current deductions system.

Table C7: Distribution of tax benefit: Deductions vs Tax Credits 2008/09

Taxable income group[1]	Marginal tax rate	Distribution of Tax Benefit			
		Medical Tax Deductions		**Medical Tax Credits**	
		(R million)	%	(R million)	%
< 0 - 40000 / 70 000	0%	564	3.6%	946	5.7%
70 000 - 120 000	18%	3 360	21.4%	5 526	33.1%
120 000 - 200 000	25%	4 474	28.4%	4 911	29.4%
200 000 - 300 000	30%	2 758	17.5%	2 351	14.1%
300 000 - 400 000	35%	1 639	10.4%	1 177	7.0%
400 000 - 500 000	38%	945	6.0%	596	3.6%
500 000 +	40%	1 988	12.6%	1 191	7.1%
Total		**15 728**	**100.0%**	**16 698**	**100.0%**

[2] *For Taxable income group <0 - R40 000 (below age 65) / R70 000 (age 65 and over), it is assumed that 50% of the amount allowed represents a cost to fiscus at the 18% rate.*

ANNEXURE D

Medical Expense Tax Treatment in Canada, Ireland and the United States

1 Canada[12]

The Canadian medical expense tax creditis anon-refundable credit, calculated as 15 per cent (the lowest tax rate) of the allowable portion of medical expenditure. The allowable portion of qualifying expenditure is the portion that exceeds the lesser of 3 per cent of the individual's net income for the yearor an indexed dollar threshold (CAD 2 052 in 2011). There is no limit on the amount of eligible expenses a taxpayer can claim for himself or herself, a spouse or common-law partner or a child under 18 years of age. There is currently a CAD 10 000 limit applicable to a "dependent" relative; however, Budget 2011 proposes to remove this limit on eligible expenses that can be claimed under the Medical Expenses Tax Credit in respect of a dependent relative. Qualifying expenses can include expenditure incurred outside of Canada. A refundable credit is available to low-income workers who incur high medical expenditures.

Canada provides tax relief for individuals through a medical expense credit, a disability credit and an attendant care expense deduction.

*The medical expense tax credit*is anon-refundable tax credit for medical expenses incurred that an individual may claim (when calculating Part I tax payable), even if such expenses were not incurred in Canada. It applies to individuals who have sustained significant medical expenses (on themselves or dependants). A refundable tax credit is available to working people with low incomes and high medical expenses.

The allowable portion of qualifying expenditure is the portion that exceeds the lesser of 3 per cent of the individual's net income for the yearor an indexed dollar threshold (CAD 2 052[13] in 2011). The medical expense tax credit (illustrated below) is determined by multiplying the allowable portion of the expenses by the lowest tax rate percentage for the year (15%).

> *Illustration:*
>
> Assume that an individual whose net income for 2011 is CAD 50 000, incurs CAD 5 000 of qualifying medical expenses. Since 3% of CAD 50 000 = CAD 1 500 is less than CAD 2 052(the 2011 threshold), the individual's medical expense tax credit is 15% of (5 000 - 1 500) = CAD 525.

The non-refundable *disability credit* is available toindividuals (as well as taxpayers who support certain dependants) who have a severe and prolonged mental or physical impairment (as certified by an appropriate medical practitioner). The credit of CAD 7 196 (2009) is for individuals of 18 years of age and older, whereas those under 18 years of age can claim an additional amount up to CAD 4 198. In addition, the unused portion of the individual's disability tax credit may be transferred to

[12] http://www.cra-arc.gc.ca/menu-eng.html [Accessed: 02 February 2010]

[13] IBFD (www.ibfd.org)

the individual's spouse or to a "supporting individual". A person entitled to a disability pension under the Canada or Quebec Pension Plan or under an insurance policy is not necessarily entitled to a disability tax credit under the Income Tax Act.

The *attendant care expense deduction* is *a*vailable to individuals who are entitled to claim the disability tax credit and who have incurred expenses for personal care that are necessary to enable them to work.

A notable feature of the Canadian system is that the tax credit applies equally to premiums for private health insurance plans and to taxpayers' out-of-pocket medical expenses[14]. As a result, the system leaves the relative price of self-insurance and market insurance unchanged.

2 Republic of Ireland

In the Republic of Ireland, tax relief for premiums paid to authorised private health insurance schemes is granted directly by the insurance company (tax relief at source – TRS). This allows the insurer to reduce the premium by the amount of the tax credit. Subscribers are required to pay 80 per cent of the gross amount to the authorised medical insurer. In effect, this reduction is the same as giving tax relief at the standard rate of tax (20 per cent).

Employees whose medical insurance premiums are paid by their employer (on their behalf), as a benefit-in-kind, do not have the allowed tax relief at source; however relief can be sought through their local revenue office.

Further tax relief for health insurance starting for people aged 50 and over (shown as Euro and Rand equivalents in the Table below) was introduced in 2009. These are specific amounts and are also granted directly by the insurer.

Table E1 and E2 show the relief for people aged 50 and over, and other health-related specific tax credits available in Ireland.

Table D 1: Tax relief for those aged 50 and over– Ireland

Age	Tax relief (Euros)	Tax relief (Rands)
50-59	€200	R1 888
60-69	€525	R4 956
70-79	€975	R9 204
80+	€1 250	R11 800

[14] Smart, M & Stabile, M. 2003. Tax Credits and the Use of Medical Care.NBER Working Paper No. 9855.

Table D 2: Medical tax credits– Ireland

€uros	2010	2009	2008	2007	2006
Home carer's credit	900	900	900	770	770
Incapacitated person – employing a carer	50 000	50 000	50 000	50 000	50 000
Incapacitated child	3 660	3 660	3 660	3 520	3 000
One spouse blind	1 830	1 830	1 830	1 760	1 500
Both spouses blind	3 660	3 660	3 660	3 520	3 000
Guide dog – allowance	825	825	825	825	825

3 The United States

The United States has a form of medical credit called the Health Coverage Tax Credit (HCTC). This benefit pays 80 per cent of a qualified health plan premium for eligible individuals. The HCTC is a unique tax credit that individuals can receive either monthly[15]as their health plan premium becomes due or yearly[16] as a credit on their federal tax return. HCTC is administered by the Internal Revenue Service (IRS).

The tax credit is potentially available to the following individuals:

- Pension Benefit Guaranty Corporation (PBGC) pension recipients who are at least 55 years old,
- Individuals receiving a Trade Readjustment Allowance (TRA) under the Trade Adjustment Assistance (TAA) program and attending TAA-approved training, and
- Individuals receiving a wage subsidy under the Alternative TAA (ATAA)/Reemployment Trade Adjustment Assistance (RTAA) program for older workers.

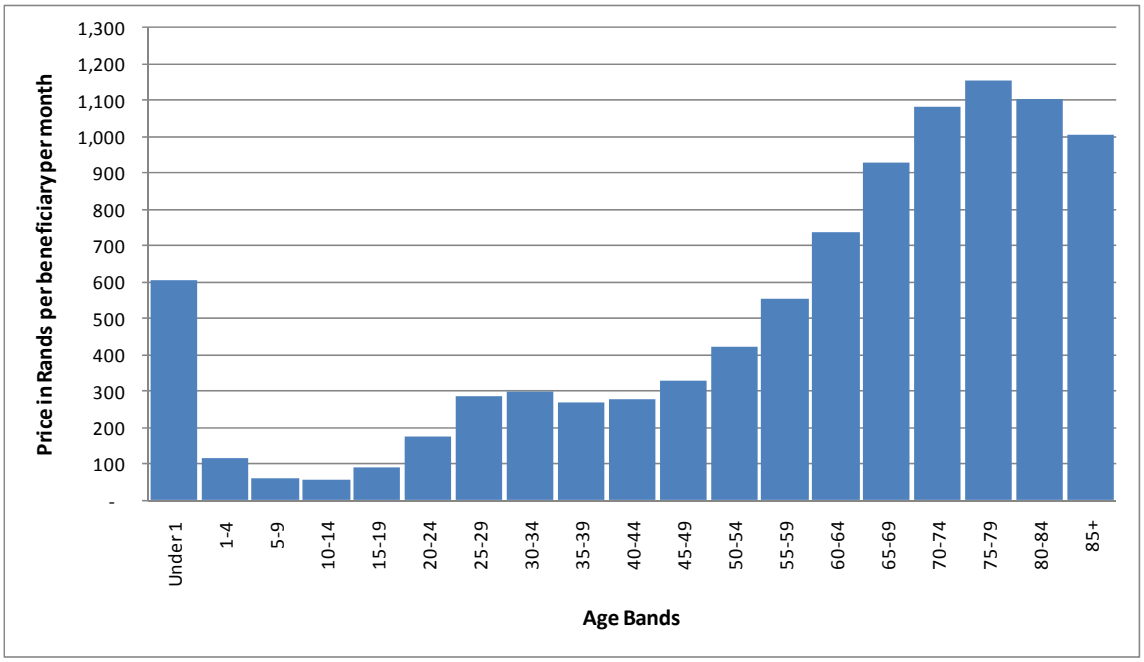
People in these three groups must also meet some general requirements and have a qualified health plan to be eligible for the HCTC. If eligible, individuals can get the tax credit for their family members as well.

[15]Individual pays 20 per cent and IRS pays 80 per cent

[16]Individual pays 100 per cent throughout the year and claims back 80 per cent at the end of the year.

ANNEXURE E

FigureE 1: Price by Age of PMB Components in 2009



(Source: Council for Medical Schemes (CMS), 2010)

Figure 1is taken from the Council for Medical Schemes 2010 REF Report and shows a very strong pattern by age in the cost of healthcare. The package of benefits used for illustration is the Prescribed Minimum Benefits[17] (PMBs) required in all medical schemes. It is quite clear that children below the age of 1 year are much more expensive than slightly older children. Not all babies in this group are expensive but there are a few very high cost babies, particularly those born prematurely. Children of school-going age are the lowest cost beneficiaries but costs escalate quite rapidly as they leave school. From approximately age 60 and above, the costs per beneficiary begin to rise above those related to the first year of infancy. This forms the basis for the argument of giving a medical scheme tax credit based on age rather than number of dependants. Those aged below five years (before entering primary school) or 60 and above should receive a bigger tax credit than those aged between five and 59.

[17]The Prescribed Minimum Benefit package is a list of some 270 diagnosis-treatment pairs (DTPs) primarily offered in hospital (introduced January 2000); all emergency medical conditions (defined January 2003); diagnosis, treatment and medicine according to therapeutic algorithms for 25 defined chronic conditions on the Chronic Disease List (CDLs) (introduced January 2004).