The tax treatment of medical scheme contributions and other medical expenses

An explanation on how the revised tax dispensation with respect to medical scheme contributions and other medical expenses will affect you.

November 2005

National Treasury
South Africa

The National Treasury and the South Africa Revenue Service (SARS), in consultation with the Department of Health, have undertaken a review of the tax treatment of medical expenses and a discussion document was released on 1 September for public comment. The tax treatment of medical scheme contributions and other medical expenses will be changed with effect from 1 March 2006. Below is a summary of the current and new tax dispensation of contributions to medical schemes and other medical expenses.

1. Taxpayers 65 years and older and retired individuals

It is important to note that taxpayers older than 65 years will continue to be able to deduct all medical scheme contributions and other medical expenses from their taxable income. Also, individuals who took early retirement but still enjoy medical scheme coverage paid for by their former employers, will continue to enjoy this as a tax-free benefit.

2. Taxpayers 65 years or younger

Three types of medical expenses qualify for preferential tax treatment:

a) Contributions to medical schemes

Members of a medical scheme can make contributions to the medical scheme themselves, their employers can make the contributions or contributions can be split between an employee and the employer.

In terms of current legislation, only the employer contribution will qualify for some preferential tax treatment (i.e. there will be no taxable value placed on the employer contribution to the extent that it does not exceed 2/3's of the total contribution). The member making medical scheme contributions out of his[1] own pocket will not be entitled to the same preferential tax treatment for such contributions.

In terms of the new legislation, all (i.e. 100% of) contributions will qualify for preferential tax treatment irrespective of who makes the contribution. This preferential tax treatment will be limited to a monetary amount of R500 for each of the first two beneficiaries and R300 for each additional beneficiary. The existing "2/3 rule" falls away.

Example 1

> Mary is employed and her employer pays 2/3's of her total medical scheme contributions. She is married and does not have any children. The total medical scheme contribution for her and her husband amounts to R1 800 per month. Thus her employer contributes R1 200 and she pays R600 from her after-tax salary. Currently, she does not pay tax on the employer contribution but with effect from 1 March 2006, she will have to pay tax on R200 of he employer's contribution as the new legislation states that only R1 000 of her medical scheme contributions (R500 each for her and her husband) will qualify as being tax exempt.

Example 2

> Dumisa is self-employed, married and has four children. He is a member of a medical scheme and his family of six is covered by this scheme. His total medical scheme

[1] Any reference to one gender also applies to the other gender.

contribution amounts to R2 300 per month or R27 600 per year (R800 for him, R600 for his wife and R300 for his first three children, the fourth child is covered but no contribution is payable). Currently he may deduct medical expenses (including contributions to a medical scheme) that are in excess of 5 per cent of his taxable income. Assuming his income is R200 000 per annum he may deduct R17 600 (being R27 600 less 5 per cent of R200 000) from this income. In terms of the new legislation Dumisa will be able to deduct R2 200 (R500 X 2 + R300 X 4) from his monthly income, or R26 400 per annum, for income tax purposes.

Example 3

Tasneems' employer is offering to contribute 2/3's of her medical scheme contributions. She is the only employed person in her family of four and the total monthly medical scheme contribution to cover her family will amount to R1 500. Her portion of this contribution will be R500 and she will benefit from a monthly tax-free employer contribution of R1 000. Although the cost seems low Tasneem is reluctant to take part in this scheme, as she will have to pay R500 per month from her net salary of R4 500. Although she will be able to get a tax refund at the end of the tax year of almost 10% of her contributions provided she submits a tax return, the cost is still too high for her.

In terms of the proposed tax regime, Tasneem will be able to reduce her medical scheme cost by 18% on a monthly basis i.e. her contribution will reduce from R500 per month to R410 per month.

The monthly monetary caps of R500 and R300 respectively will be reviewed annually in consultation with various stakeholders. In 2007, consideration will be given to appling the higher monetary cap of R500 (as adjusted) to contributions for adults and the lower monetary cap of R300 (as adjusted) to contributions for children.

b) Medical expenses paid by individuals (including medical scheme contribution paid by the individual)

Medical expenses paid for by the taxpayer in excess of 5 per cent of his income, are tax deductible. This threshold will increase to 7,5 per cent from 1 March 2006 and will exclude medical scheme contributions which qualifies as a tax deduction under a). Where a taxpayer has a disability or has a dependant with a disability all medical expenses of the family unit will continue to be tax deductible.

Example 4

Vusi is single and his employer pays 2/3 of his medical scheme contributions. His total monthly medical scheme contribution is R750 of which his employer pays R500. Vusi's contribution towards his medical scheme is therefore R250. In addition he incurred other out of pocket medical expenses (due to an unforeseen injury) of R2 000. These expenses were not covered by the medical scheme. The cost of his medical expenses for the year was therefore R5 000. In terms of the new legislation the employer contribution to his medical scheme coverage will remain tax-free. He will also be allowed to deduct medical expenses exceeding 7,5 per cent of his income. His salary is R50 000 per annum and he is therefore allowed to deduct all medical expenses in excess of R3 750. The cost of his actual medical expenses is R5 000 and he may therefore claim R1 250 (R5 000 less R3 750) as a tax deduction for this particular tax year.

c) Employer provided medical treatment

Currently, no taxable benefit will arise for the employee where the employer provides medical treatment to employees at their place of work. Such medical treatment is normally covered under a company's occupational health initiative. However, should the medical treatment be provided to employees' families, employees would be liable to pay tax on the value of this benefit. Where the employer pays for medical treatment for the employee and/or his family and this treatment is provided at a place other than the employee's workplace, the employee will have to pay tax on the value of this benefit.

In terms of the new tax dispensation, all benefits derived from employer provided medical treatment (on- and off-site) will be tax-free in the hands of the employee, provided certain criteria are met. Only Prescribed Minimum Benefits may be provided tax-free at an off-site location. In cases where the off-site employer provided medical treatment constitutes the business of a medical scheme it must be granted exemption from complying with the requirements of a medical scheme by the Registrar of Medical Schemes in order to qualify for tax-free treatment. Where the off-site medical treatment does not constitute the business of a medical scheme it may be provided tax-free if it is only provided to employees (or their immediate dependants) who are not members of a medical scheme.

Example 5

> John is not a member of a medical scheme and he and his wife are HIV positive. His employer funds a confidential off-site HIV/AIDS programme for its employees and their immediate families at a monthly cost of R500 per person treated. John and his wife participate in this employer programme and receive free medical treatment. Currently John is liable to pay income tax on the monthly fringe benefit of R1 000 and the confidentiality of the programme is jeopardised due to this tax charge. In terms of the amended income tax legislation John will receive this benefit tax-free provided the abovementioned criteria is met.

3. Who qualifies as a dependant

The Income Tax Act was amended to include a definition of dependant for purpose of medical scheme contributions. The new definition is in line with the definition of dependant in the Medical Schemes Act and recognises the fact that an individual may want to extent coverage to persons other than his immediate family. Medical scheme contributions made by the taxpayer to cover his parents or other persons in his care will qualify for preferential tax treatment.

However, in the case of out of pocket medical expenses only expenses incurred in respect of immediate family members i.e., spouses and children will qualify for preferential tax treatment. This more restrictive definition also applies to employer provided treatment and is aimed at limiting abuse and to favour wider medical scheme coverage.