6th Report - BENEFIT FUNDS

CHAPTER 1 - INTRODUCTION

1.1 The Income Tax Act recognises three categories of benefit fund. These are:

(a) Friendly Societies;

(b) Registered Medical Schemes; and

(c) an omnibus category - often referred to as "para (c) benefit funds" - which depend for their recognition on approval by the Commissioner, and are described in more detail in section 5 of this Report.

1.2 Benefit funds have an income tax regime of their own. Its nature may be summarised under four headings:-

(i) taxation of the fund itself;

(ii) tax treatment of contributions by employers;

(iii) tax treatment of contributions by members, who are usually (but not always) employees; and

(iv) the tax status (i.e. "capital" or "income") of benefits received from a fund, and their tax treatment if regarded as income.

An introductory discussion of these matters occupies the rest of this section.

1.3 The fund itself:

Benefit funds are exempt from income tax. This exemption extends to contributions received and to investment income earned on amounts accumulated - the so-called "roll-up". Tax-exemption has certain other advantages, not least being access to the "untaxed policyholder funds" of long-term insurers. This normally allows members to enjoy insurance cover on terms more favourable than would otherwise be available to them.

1.4 Contributions by employers:

Employers may claim deduction of contributions made on behalf of their employees, subject to certain limits. These limits are:

(i) expressed as a percentage of each individual employee's "approved remuneration";

(ii) largely within the discretion of the Commissioner, except where they do not exceed 10%; and

(iii) calculated, for each employee separately, by lumping together the contributions made on his or her behalf in respect of benefit *and retirement* funds - although retirement funds are not themselves regarded as benefit funds for any purpose other than seeing whether or not the limit has been exceeded.

1.5 Provided they are within the approved limits employer contributions to benefit funds do not create fringe benefits that are subject to tax in the hands of the employee. That is the position in terms of current practice. The Commission expresses no view on the correct interpretation of the law as it stands.

1.6 Employer contributions that are repaid on the withdrawal of a member are taxed in the employer's hands to the extent that they represent a "recoupment" of expenditure previously allowed as a deduction. To the extent that they exceed that amount (either because some deductions were disallowed or because the fund rules allow the employer to claim a share of the investment roll-up), they are received tax-free. Partly for this reason, the Commissioner has in recent years declined to approve para (c) funds that have such rules.

1.7 Contributions by members:

Subject to two exceptions, noted briefly below, member contributions to benefit funds do not rank for deduction from income subject to tax. They must be made out of after-tax income.

1.8 The first exception relates to contributions to registered medical schemes made by the elderly; and by those of working age who have had to incur medical expenses exceeding the greater of R1000 and 5% of income. They may claim a deduction. The dispensation for handicapped persons is slightly more generous.

1.9 The second exception relates to contributions to benefit funds that provide disability benefits in the form of income-replacement policies. As the benefit (usually in the form of an annuity) is fully taxed as income, contributions to cover the premiums are deductible on ordinary tax rules as "expenses in the production of income."

1.10 Benefits received by members:

The tax treatment of benefits is not entirely straightforward. The examples to be given are intended to do no more than indicate the degree of complexity. It has just been noted that a benefit received as an annuity is taxed as income. On the other hand, payments by a registered medical scheme to or on behalf of its members, to indemnify them against medical expenses actually incurred, have no tax consequences. The status of lump sum payments is less clear-cut.

1.11 Lump sum proceeds of insurance policies giving protection against the occurrence of a "stated event" such as accident or illness are normally regarded as capital receipts, and not taxed. If in due course used to meet medical expenses they may (from an income tax point of view) do even better than that, and give rise to a deduction.

1.12 However, lump sum payments whose receipt coincides with the termination of employment (whether because of withdrawal, retrenchment, ill-health, old age or death) may be regarded as falling within the definition of "gross income" and taxed at marginal rates to the extent that they exceed three years' earnings. Up to that level they may be taxed at a concessionary average rate; and in addition the taxpayer may qualify for a one-off tax-free allowance of R30,000.

6th Report - BENEFIT FUNDS

CHAPTER 2 - THE NEED FOR REFORM

2.1 The tax regime applicable to benefit funds, sketched in the last section, was not designed as a coherent whole. It has developed piecemeal over a number of years. It is complex. It contains anomalies. It is open to abuse. A view on the extent to which it is in fact abused cannot be formed until each of the three categories of fund has been examined in more detail. That will be done in the sections that follow. This section concentrates on some of the more obvious matters that require attention.

2.2 Salary sacrifice:

Any regime that grants tax deductibility in respect of contributions made by the employer, but denies it to the employee, opens the door to salary sacrifice schemes. Their operation is simple. The employee accepts a lower salary but in return expects the employer to spend an equivalent amount in meeting the cost of contributions to this or that benefit fund of the employee's choice. The employee gets fund membership without having to purchase it out of after-tax income, and at no net cost to the employer. Obviously, this is attractive only to employees paying significant tax. Salary sacrifice is of no interest to those earning low incomes. Obviously, too, salary manipulation is a device unavailable to the self-employed, who have neither salaries to sacrifice nor employers to make tax deductible contributions on their behalf.

2.3 In the example just given the employer is left in a neutral position, the new salary plus benefit fund contribution being just equal to the old salary - and both being fully deductible. More typically the amount gained by the employee at the expense of the fiscus is shared between the parties.

2.4 Salary sacrifice schemes are common to all income tax systems where deductibility rules are asymmetrical, and attractive to all employees whose marginal tax rates are high. It is possible to attack the schemes directly, but much simpler to amend the rules. The Commission's recommendations will follow the latter course.

2.5 Deductibility limits:

The present deductibility limits are largely discretionary and their application to employees on an individual basis, rather than as a group working for one employer, is administratively cumbersome. The lumping together of contributions to benefit and retirement funds in determining the limits is essentially inappropriate, given the differing tax regimes to which the benefits are subjected. All three matters require attention.

2.6 Employers whose contributions exceed whatever limits have been set by the Commissioner may, if taxpayers, attempt to deduct the excess as "expenses in the production of income" under the normal tax rules. In most cases they are unlikely to succeed, in view of a recent amendment to the Act. This is, however, not a sanction likely to inhibit employers who are outside the tax system (e.g. municipalities, para-statals and most N.G.O's) from doing as they please.

2.7 It would appear to be necessary to amend the Act's Fourth and Seventh Schedules (which deal with these matters) to provide that employer contributions to benefit funds in excess of the approved limits be allocated to individual employees on a basis satisfactory to the Commissioner and taxed as income in their hands through the PAYE and SITE systems. The Commission recommends accordingly. Acceptance of the recommendation will go a long way towards securing compliance by both taxpaying and non-taxpaying entities.

2.8 In paragraph 8.7.10 of its Third Interim Report the Commission recommended that separate deductibility limits be set for retirement and benefit funds. Further consideration has persuaded it that each of the three categories of benefit funds should be treated separately. This is done in the individual sections dealing with those categories.

2.9 The views put forward in paras 2.5 and 2.8 above, run contrary to those embodied in section 11(*l*) of the Income Tax Act, which is the one dealing with the limits to be placed on employer contributions to benefit funds. It is recommended that it be repealed and replaced by one based on the approach adopted in this Report.

2.10 The tax-free roll-up:

In chapter 8 of its Third Interim Report the Commission drew attention to the use of retirement funds as tax shelters and emphasised the crucial part played by the tax-free status of their investment roll-up. It was the sheer size of the funds administered by the industry and the fact that they could be used on a massive scale to shelter non-retirement income that caused the Commission to recommend remedial action. It is therefore important to get some idea of the size of the various parts of the benefit fund industry. What information is available will be analysed in the relevant section. Unfortunately it is not complete.

2.11 The triple combination of tax-deductible contributions, a tax-free investment roll-up and benefits that are often treated as capital receipts, or taxed as income at concessionary rates, provides ample scope for avoidance and requires careful monitoring. To that we must now turn.

6th Report - BENEFIT FUNDS

CHAPTER 3 - FRIENDLY SOCIETIES

3.1 Friendly societies are essentially mutual organisations, in the sense that the members are the owners. They were once known as mutual aid societies. No employer - employee relationship is required. They have a long history in South Africa, legislation regulating them having been enacted as early as 1882 in the Cape and 1897 in Natal. The present Act dates from 1956 and their supervision is now in the hands of the Financial Services Board.

3.2 In theory the range of services that may be provided to its members and their dependants by a friendly society is very wide - so wide, in fact, that most *stokvels* would have to register were it not for an exemption granted societies with annual incomes below R100 000. The range includes relief during minority, old age, widowhood and sickness; the granting of annuities and endowments; payments on the birth of a child or death of a family member; funeral expenses; insurance of implements used in a member's trade; financial assistance on resignation or dismissal; unemployment relief and "the provision of sums of money for the advancement of the education or training of members or of the children of members."

3.3 In practice, however, severe limitations are placed on what friendly societies may actually do. Despite being allowed to offer relief in old age they may not provide retirement benefits. Despite being allowed to pay annuities, no annuity may exceed R144 p.a. without falling foul of the Insurance Act. No death, disability, endowment or other benefit (which the Registrar of the Insurance considers to be an insurance benefit) may be offered if the amount (including bonuses) exceeds R5 000. A society is precluded from regularising the matter by registering as an insurer, as only companies may register as insurers - and friendly societies are not companies.

3.4 The predictable result of these limitations is that the friendly society movement, while old and stable, has not flourished. The total assets of the 109 societies submitting returns to the Registrar in 1994 did not exceed R200 million. This is less than one tenth of one percent of the volume of assets in the retirement fund industry. (See Third Interim Report, para. 8.1.2). There are no grounds for believing that it does, or can, provide a significant tax shelter. There are therefore no grounds for suggesting a tax on the investment roll-ups of friendly societies. The Commission accordingly recommends that the existing exemption remain in place.

3.5 The total contribution flow to the friendly societies that rendered returns in 1994 was some R34 million, of which R26 million came from members and R8 million from employers. It appears, from informal enquiries, that a substantial number of the employers were tax-exempt institutions. The implication is that only a small portion of the contribution flow, probably between 10 and 15 percent, enjoyed contribution deductibility, and that the balance was from after-tax income.

3.6 It is possible to draw either of two very different conclusions from the above figures on contribution flow. The one is that salary sacrifice schemes have not yet penetrated the friendly society environment, that the loss to the fisc from allowing contribution deductibility to employers is small and that no real purpose would be served by introducing limits on the extent of that deductibility. The other possible conclusion is that salary sacrifice has not come on to the scene precisely because most members of friendly societies earn incomes that are not subject to high rates of tax - so there is no incentive to negotiate salary sacrifice and no role for employer contribution deductibility to play in encouraging membership.

3.7 The Commission has hesitated between these two conclusions but come to the firm view that the second is correct and that the appropriate course of action is to recommend, as it now does, the removal of employer contribution deductibility, thereby restoring symmetry between employee and employer in the friendly society environment and removing any possibility that salary sacrifice will become a significant factor in future. A reasonable period of notice, say one or two years, should be given of the proposed change to allow wage negotiations to take it fully into account. The fiscal implications would, under present circumstances, appear to be very small and neither party to the negotiations should have difficulty in making the necessary adjustments.

3.8 In clarification of the above remark it should be noted that, if the Commission's earlier recommendation (in para. 2.7) is accepted, employer contributions to friendly societies in excess of the approved limit - in this case, zero - will be taxed as fringe benefits and subjected to SITE. Obviously, if an employee is paying tax at a very low rate, or is out of the SITE system altogether, the effect on take-home pay will be small or non-existent.

3.9 A factor that has not yet emerged in the published reports of the *Registrar of Friendly Societies* has reinforced the Commission in its view that, in this context, removal of employer contribution deductibility is the appropriate recommendation. That factor is the appearance of friendly societies offering educational policies of the sort mentioned at the end of para. 3.3 and recruiting members drawn from income brackets where marginal tax rates are high and salary sacrifice schemes attractive. The combination of salary sacrifice, employer contribution deductibility, tax-free roll-up and possibly tax-free educational policy payments creates too powerful a tax planning environment to be left wholly intact. Removal of contribution deductibility (and, with it, much of the attractiveness of salary sacrifice) will go some way towards restoring a balance, but may not be enough.

3.10 The "caps" on insurance products offered by friendly societies were described in para. 3.3. They have succeeded, perhaps too well, in limiting growth. It may be thought that, if deemed necessary, similar "caps" could be placed on educational products. The matter may not be so simple. Rival insurance products, offered by registered insurers, have always been available. There is no real rival to the sort of educational product a friendly society is capable of offering. The incentive to circumvent any "caps" imposed would be strong. Multiple membership (i.e. both parents acquiring membership of a number of societies) would defeat the "caps" entirely and be very difficult to control. A solution must be sought elsewhere.

3.11 The Commission recommends that the growth of educational products offered by friendly societies be closely monitored and that appropriate action be taken if it is found that they are being marketed to income groups not traditionally associated with the friendly society movement. Such action could embrace an amendment to the Friendly Societies Act requiring the establishment of separate societies for educational products, and an amendment to the Income Tax Act making the investment roll-up taxable in the hands of such societies.

6th Report - BENEFIT FUNDS

CHAPTER 4 - REGISTERED MEDICAL SCHEMES

4.1 Background:

The Registrar of Medical Schemes, in conjunction with a Council appointed by the Minister of Health, administers the Medical Schemes Act of 1967. Certain departments of state (defence, police, prisons) are not subject to its provisions; and certain industrial schemes are registered in terms of the Labour Relations Act. The latter are required to supply the Registrar with statistical information on a regular basis, so his Reports contain figures relating to about 85% of the industry.

4.2 The figures in the 1995 Report relate to 1994. In that year there were over six million beneficiaries (i.e. members plus dependants) in some 200 schemes. The annual contribution flow was nearly R14 billion. Total assets amounted to some R5,5 billion, net assets to R2 billion. The schemes are clearly run on a pay-as-you-go basis.

4.3 Two broad comparisons need to be made to put these figures in perspective. The first is with friendly societies. The medical schemes industry is clearly much the bigger - with an asset base 25 times, and an annual contribution rate 400 times, larger.

4.4 The second comparison is with the retirement funds industry. (Figures for the latter are given in chapter 8 of the Commission's Third Interim Report). The annual contribution flow to medical schemes is more than half that to retirement funds, but their asset base is less than one-fiftieth. That is another indication of the extent to which they rely on pay-as-you-go financing.

4.5 The investment roll-up:

The comparatively small volume of assets in the medical schemes industry leads to the same conclusion that was reached in the context of friendly societies. There is no significant danger of the industry being used to shelter other income, and no significant scope for tax arbitrage. The existing exemption from tax on the investment roll-up should remain in place. The Commission recommends accordingly, but places on record that the matter should be kept under continuous review if medical schemes in due course become vehicles for pre-funding post-retirement medical expenses. Such a development would necessarily involve the accumulation of substantial volumes of assets and change the situation fundamentally.

4.6 Contribution deductibility - members:

As mentioned in para. 1.8, the rule that member contributions to benefit funds have to be made out of after-tax income is breached in respect of contributions to registered medical schemes. Taxpayers over 65 years of age may deduct in full. Taxpayers who are younger may deduct to the extent that their contributions form part of medical expenses that are (in a defined sense) exceptionally high, and for that reason themselves qualify for deduction.

4.7 The reason why medical expenses may themselves qualify for deduction when they are high is often misunderstood. It is not simply to provide a tax incentive to encourage people to pay their own medical costs and stay out of state hospitals. It is to make the tax system work. The successful taxation of income depends essentially on ability to pay. High medical costs impact directly on that ability. No income tax system that ignores their impact can hope to remain viable. This is especially true of a system with a rate structure that is progressive.

4.8 Full allowance for high medical expenses is really only feasible on assessment. For sound administrative reasons (set out in para. 8.5 of the Commission's First Interim Report) most payers of income tax are not on register, do not render returns and do not receive assessments. They are subject to the SITE system, which applies to employees earning less than R60 000 p.a. in "standard employment". In most cases SITE is a final tax, but anyone subject to it may render a return and claim a refund if exceptionally high medical expenses have been incurred. The smooth working of the system depends in a very important sense on these cases being limited to an absolute minimum. That is the real justification for encouraging medical scheme membership by granting a measure of contribution deductibility. It is a mild fiscal incentive, but a very necessary one.

4.9 It is possible that extensions to the SITE system, such as the one proposed in the 1997 Budget, may in due course require an upward revision of the percentage of income which, when expended for medical purposes, is regarded as being high enough to trigger deductibility. This will be the case if the number of SITE payers asking for assessment increases substantially. The Commission recommends that the matter be monitored on an on-going basis.

4.10 Deductibility limits - employers:

Many of the early medical aid funds were employer driven. Many of today's registered schemes confine themselves to the employees of a single employer. Employer contributions have always constituted an important part of the total contribution flow to such schemes. As membership often includes employees in high tax brackets, salary sacrifice arrangements have become commonplace and very attractive to both parties. They have also become very unfair to self-employed persons, who are obviously unable to participate in them.

4.11 It has been suggested that employer contributions should be limited to a percentage of payroll. This is not a satisfactory proposal. Firstly, not all members of a workforce are normally scheme members - some are almost certain to be "dependants" of members who belong to other schemes. Secondly, earnings (except where related to age) are a poor indication of risk. Age itself, and the number of dependants, are the two most significant factors. These are best determined on an individual basis.

4.12 The Commission recommends that an employer be entitled to claim a contribution deduction in respect of its employees to a registered medical scheme on a "rand for rand" basis. That is to say, for every R1 contributed by employees, the employer be entitled to contribute another R1 and claim it as a deduction from taxable income.

4.13 It is to be emphasised that limiting employer contribution deductibility in the way recommended will not eliminate the attractions of salary sacrifice. It will, however, reduce them - on most methods of calculation by about 50%. It may in due course be desirable to tighten the limit and reduce the attraction further; but it must not be overlooked that some fiscal encouragement to medical aid is part of the price we pay for getting a SITE system that works.

4.14 Self-employed persons:

To achieve equity between self-employed persons and those in employment, and on the assumption that its previous recommendation regarding the "rand for rand" basis for determining employer limits is acceptable, the Commission recommends that a self-employed person be entitled to deduct 50% of his or her contributions to a registered medical scheme. This would not, of course, preclude deduction of the balance if the total of contributions and other medical expenses were sufficiently high to trigger the concession noted in para. 1.8.

Medical savings accounts:

4.15 Certain medical schemes, in an effort to encourage members to manage their medical costs with prudence and frugality, offer medical savings accounts. These accumulate (in the member's name) if claims are low, and may be accessed to meet major medical expenses or when scheme limits would otherwise be exceeded. In some schemes they may be retained until the member retires and then used to defray his or her post-retirement contributions.

4.16 The interest earned on these accounts is not exempt income. It accrues to the member in whose name the account is held and is subject to tax in his or her hands. That much is clear, but there are administrative difficulties. The amounts may be small; the member may not be on register; his or her total interest income may be below the R2,000 threshold at which such income becomes taxable. Hence, the matter calls for a different solution.

4.17 Bearing in mind that the account may have been built up, at least in part, with tax-deductible contributions negotiated by salary sacrifice, it seems appropriate that any solution proposed should be able to cope with the problem of "cash withdrawals". This term is used in a wide sense to refer to any payment (other than a transfer to another registered medical scheme) that is not for *bona fide* medical expenses of members and their dependants. The Commission therefore recommends that a final withholding tax be imposed on interest credited to, and "cash withdrawals" from, medical savings accounts. It is not for the Commission to recommend the rate, but it should not be too far below the corporate rate if tax arbitrage is to be discouraged.

4.18 Low-claim bonuses:

Bonuses to reward members for no or low claims are offered by certain schemes, usually (but not exclusively) on withdrawal. They are in many respects similar to medical savings accounts and should be subject to the same withholding tax regime. The Commission recommends accordingly.

4.19 Certain technical problems:

The Commission has become aware of certain problems relating to the wording of

i. paragraph (b) of the definition of 'benefit fund' in section 1; and
ii. section 18 (1) (a)

of the Income Tax Act, No 58 of 1962. In both instances reference is made to "any medical scheme registered under the provisions of the Medical Schemes Act.....", thereby excluding both statutory schemes and those registered in terms of other legislation. It is recommended that the wording be amended to conform more closely to current practice.

6th Report - BENEFIT FUNDS

CHAPTER 5 - PARAGRAPH (C) BENEFIT FUNDS

5.1 Paragraph (c) of the definition of "benefit fund" in section 1 of the Income Tax Act describes what has come to be called a "para (c) fund" as follows:

"any fund (other than a pension fund, provident fund or retirement annuity fund) which, in respect of the year of assessment in question, the Commissioner is satisfied is a permanent fund bona fide established for the purpose of providing sickness, accident or unemployment benefits for its members, or mainly for such purpose and also for the purpose of providing benefits for the dependants or nominees of deceased members."

This, as far as the Commission is aware, is the only reference to a para (c) fund in any legislation anywhere.

5.2 While nominally established by the terms of a Trust Deed (which will determine its objects, provide for the rights and obligations of its members and appoint its first trustees) a para (c) benefit fund is essentially a creature of the Income Tax Act. Access to the favourable tax regime under which benefit funds operate depends on the Commissioner's discretion, not on registration in terms of some other Act or regulation by some other authority. There *is* no other Act, or other supervisory authority.

5.3 Information on para (c) funds as a group is therefore difficult to obtain. It is known that they number over 20 000. It is not known how large their contribution flow is, or what volume of assets they control. It is known that some operate very close to the line intended to demarcate the area reserved for registered insurers; and others very close to the one indicating the area reserved for medical schemes. It is not known how many have strayed into those areas and are in fact operating illegally.

5.4 An insurer contracts to pay a fixed sum of money (possibly as an annuity) on the occurrence of a stated event such as sickness, the diagnosis of a dread disease, accident or hospitalisation. Once it has discharged its obligation it has no interest in the insured's medical expenses as such. Providing indemnity against actual medical expenses (though not necessarily without limit) is the preserve of the medical scheme. The insurer must register under the Insurance Act, the medical scheme (unless exempt) under the Medical Schemes Act. Their areas of operation are well defined, but very close. It is not immediately clear that there is room for 20 000 para (c) funds to operate between them without trespassing.

5.5 Among the benefits that may be offered by a para (c) fund are those relating to unemployment. A friendly society is also entitled to operate in that field. There would appear to be no compelling reason why the one entity should be preferred to the other. Possibly the friendly society scores an advantage in so far as it is subject to the discipline of the Friendly Societies Act and to supervision by the Financial Services Board, whereas the para (c) fund is a law unto itself.

5.6 The Commission has consulted widely and concluded that it should recommend that, after a reasonable period of notice, the definition of "benefit fund" in the Income Tax Act should be amended by the elimination of paragraph (c).

5.7 Para (c) funds will have a number of courses of action open to them if the above recommendation is accepted. Some may choose to continue operating as before, but without the special tax privileges; others will prefer to wind themselves up. A few that have been designed as vehicles to pre-fund post-retirement medical expenses may find it preferable to register as pension funds. Those wishing to continue to enjoy the benefit fund tax regime will have to register as medical schemes or friendly societies. The balance will no doubt seek registration as either short or long-term insurers.

5.8 The "reasonable period of notice" referred to in the recommendation in para. 5.6 should be long enough to enable the funds to take appropriate action in a considered manner and to allow the authorities time to cope with the spate of registrations that may ensue. During the interim period no new para (c) funds should be approved. In principle no temporary changes to the tax regime, as it affects existing para (c) funds, should be contemplated. It may nevertheless be necessary to "freeze" contributions at existing levels during the phasing-out, especially if section 11(*l*) is repealed before the process is concluded.

5.9 The migration of para (c) funds to environments where legislation is in place and supervision mandatory will not be complete. The funds choosing to continue as before but without the tax advantages they previously enjoyed will no doubt be those established for sound business reasons unrelated to tax. Whether or not they should in due course be required to report to a supervisory body such as the Financial Services Board is a matter that can be decided at a later date.

5.10 Disability benefits:

From submissions received it is clear that many para (c) benefit funds exist to house disability income insurance schemes (often referred to as PHI, or permanent health insurance). There are several reasons for this, not all of them tax-related, and it may well be that most will continue as before when their tax advantages are withdrawn. It has, however, been suggested that their natural home is in the retirement fund environment.

5.11 The matter is not entirely simple. A distinction has to be drawn between *permanent* and *temporary* disability. The former implies retirement from work and can be appropriately accommodated in the retirement fund environment, as indeed it often is at present. The latter implies no more than an interruption of normal work. It may occur many years before actual retirement. Because of the way the terms are defined in the Income Tax Act, the Commissioner is not entitled to approve the rules of pension or provident funds that offer benefits of an income-replacement type prior to death or retirement.

5.12 There is no reason why the definitions in the Act should not be amended to permit retirement funds to offer temporary disability income insurance if the industry finds that an administratively convenient way of doing business. It could, however, have adverse tax consequences for the insured. Premiums paid on income-replacement policies are tax deductible if paid (either directly, or through a broker) to an insurer. If channeled through a retirement fund they may result in the fund's deductibility limits being exceeded. It does not seem appropriate to recommend an increase in the limits to accommodate a type of insurance for which a tax-neutral regime is currently in existence.

6th Report - BENEFIT FUNDS

CHAPTER 6 - MEDICAL INSURANCE

6.1 The difference between medical insurance and the indemnity cover offered by registered medical schemes has been explained in the last section. It will not be repeated.

6.2 Medical insurance has an independent existence outside the benefit fund environment but nevertheless co-exists within it largely through para (c) funds, in order to take advantage of a favourable tax regime. It brings with it several desirable qualities (such as the scientific evaluation of risk and the ability to encourage the sensible self-management of medical costs) that have prompted suggestions that it be made a more welcome guest. These suggestions are likely to acquire a new urgency if para (c) benefit funds are to be phased out.

6.3 In 1994 the Melamet Commission reported on *The Manner of Providing for Medical Expenses*. It emphasised (p.94) the advantages of using the concepts of savings and insurance to manage the health care needs of employees, rather than the method of cross-subsidisation currently offered by medical schemes. It recommended (p.45) that "if and to the extent that subsection 11 (*l*) of the Income Tax Act is retained as it is then its scope should be extended to embrace the insurance industry". Although the repeal of section 11(*l*) has been recommended in para. 2.9 of the present Report, the above views expressed by the Melamet Commission remain extremely relevant.

6.4 In effect the Melamet Commission concluded that the insurance industry offered products that competed with those offered by medical schemes; that in certain respects they were superior products; but that insurers were at a fiscal disadvantage in competing and that contribution deductibility should be extended to them on the same basis as to medical schemes.

6.5 The Commission has given careful consideration to the matter and is impressed by the argument. It nevertheless cannot support the Melamet Commission's recommendation that employer contribution deductibility be extended in the way suggested. The reason is that, in so far as the proceeds of insurance policies are lump sum payments, they are normally treated as capital receipts. If a payment coincides with a major medical expense, and is used to meet that expense, a deduction is normally triggered. It would appear to be unnecessary to give an up-front contribution deduction as well. It should be mentioned that in so far as the proceeds of insurance policies are not lump sum, but in the form of income-replacement, premiums paid are in any case deductible under the current rules.

6.6 Certain insurance products offering lump sum benefits to employees may be purchased by employers in terms of contracts of employment. The premiums paid will then normally qualify for deduction as being "expenses in production of income." It is not clear that the definitions of "remuneration" in the Fourth Schedule (which deals with the PAYE and SITE systems) and of "taxable benefit" in the Seventh (which deals with fringe benefits) are sufficiently widely drawn to capture the payment of such premiums. It is recommended that the Act be appropriately amended.

6th Report - BENEFIT FUNDS

CHAPTER 7 - PRE-FUNDING VEHICLES

7.1 Several submissions to the Commission stressed the need for financially sound, tax-efficient vehicles that could be used by employers, employees and the self-employed to pre-fund post-retirement medical expenses, or at least the cost of retaining post-retirement medical scheme membership. A full discussion is beyond the Commission's terms of reference, but several points need to be made. Comment will be restricted to the position of employees and the self-employed.

7.2 In chapter 8 of its Third Interim Report the Commission proposed a new tax regime for retirement funds. It is the Commission's view that the regime proposed can easily be adapted to render retirement funds attractive pre-funding vehicles and that they are, by their very nature, the appropriate vehicles for pre-funding all the expenses of retirement, including medical scheme membership. Financial regulation, actuarial supervision, prudential investment requirements, reasonable portability, established procedures for providing survivor benefits and protection against insolvency are all in place.

7.3 The regime proposed included new deductibility limits, a tax on the taxable element in the investment roll-up, taxation of the capital value of the benefit emerging on retirement and the possibility of tax-free pensions in old age. The formula proposed for calculating the tax on the capital value of the benefit gave the retiree quite a strong incentive to choose a pension rather than a lump sum in selecting the form in which he or she was to receive the benefit. It is a simple matter to adapt the formula to give an additional incentive to the retiree to set aside a part of the benefit to purchase a second annuity dedicated to covering the cost, in whole or in part, of retaining medical scheme membership.

7.4 Any incentive has a cost. In this case the cost of the proposed additional incentive is likely to be small. That is because most people retire at (or near) the age at which medical expenses actually incurred become fully deductible. Allowing the deduction up-front, when the capital value of the benefit is taxed, represents no more than an acceleration of a series of deductions that would in any case have been allowed in full as medical scheme contributions were paid.

7.5 More specifically, the formula originally suggested in the Third Interim Report reduces the taxable amount of the benefit, on a sliding scale, by the capital value of any annuity purchased. It is now suggested that a further reduction be granted in respect of the capital value of an additional annuity dedicated to meeting (in whole or in part) medical scheme contributions. It is further suggested that this additional annuity's capital value should not be permitted to exceed R120 000.

7.6 The formula proposed in the Third Interim Report requires independent adjustment to take account of the changes to tax rates and brackets that have occurred since its publication. Detailed work has been done to ensure that the new proposals are compatible with the adjusted formula. The Commission is able to report that they are.

7.7 The new deductibility limits for retirement funds proposed in the Third Interim Report were 7.5% (of approved remuneration) for employees and 15% for employers. The full 22.5% was to be allowed the self-employed. It has been suggested that these limits are too low to permit the funding of both an adequate pension and a realistic allowance for post-retirement medical expenses.

7.8 This is not a matter on which it is wise to be dogmatic. Actuarial advice has been received that indicates that on most realistic lifetime earnings profiles, saving 22.5% of income will indeed fund a pension adequate in relation to pre-retirement income and leave a surplus for continuing medical scheme membership. Obviously this pre-supposes that the savings start early and continue throughout a full working life. No one can hope to accumulate sufficient funds on which to retire if saving is postponed to the last few years of employment.

7.9 There is, however, another matter on which dogmatism *is* appropriate. While the state relies on personal income taxation for some 40% of its revenue, allowing a deferral of tax on *more* than 22.5% of income is bound to result in the levying of tax on the balance at rates that are uncomfortably high - both on average and at the margin. On these grounds alone, an increase in the deductibility limits cannot be supported.

CHAPTER 8 - CONCLUSION

8.1 To a certain extent the Commission has side-stepped the difficult task of reforming the benefit fund tax regime by recommending, in effect, that the majority of funds - the so-called para (c) ones - be forced to migrate to other environments where well established, but different, regimes already exist. But that is not the whole story, as the following paragraphs will show.

8.2 Friendly societies lose the privilege of receiving tax deductible contributions from employers, but retain their tax-exempt status. That means that a society's investment roll-up remains untaxed and that it can continue to have access to the untaxed policyholder funds of long-term insurers.

8.3 Salary sacrifice schemes are made less attractive to members of registered medical schemes by limiting employer contribution deductibility on a "rand for rand" basis. The self-employed are treated more equitably by being allowed a 50% deduction.

8.4 Within registered medical schemes, a final withholding tax is proposed on interest credited to, and cash withdrawals from, medical savings accounts. No and low claim bonuses, if paid in cash, are subjected to the same withholding tax. The scheme itself retains its tax-free status.

8.5 Certain amendments are proposed to the Fourth and Seventh Schedules of the Income Tax Act that will encourage compliance with deductibility limits by both taxpaying and non-taxpaying entities. Another proposed amendment widens the definition of registered medical scheme. The repeal of section 11(*l*) is recommended.

8.6 Attention is explicitly drawn to the importance of setting deductibility limits for medical expenses (which include contributions to registered medical schemes) that enable the SITE system to function smoothly.

8.7 Warnings are sounded that continuous monitoring of the volume of assets held by friendly societies as a group, and by medical schemes as a group, is advisable. Assets will accumulate rapidly if pre-funding for children's education is done on any scale through the societies; or if pre-funding for post-retirement expenses is done by the medical schemes. In both cases appropriate taxation of the investment roll-up could be required to counter arbitrage and the use of the funds to shelter other income. It is emphasised, however, that this situation has not yet been reached.

8.8 A more detailed summary of the Commission's formal recommendations is reserved for the next section.

6th Report - BENEFIT FUNDS

CHAPTER 9 - SUMMARY OF RECOMMENDATIONS

9.1 This section lists the Commission's formal recommendations, grouping them under various headings. The numbers in parentheses refer to the paragraphs in which they were originally made. These should be consulted for qualifications that are not repeated in what follows.

9.2 Friendly societies:

It is recommended that:-

- the investment roll-up remain untaxed (3.4).
- after a reasonable period of notice, employer contributions no longer be tax deductible (3.7).
- the growth of educational products be closely monitored and that appropriate action
  be taken if it is found that they are being marketed to income groups not traditionally associated with the friendly society movement (3.11).

9.3 Registered medical schemes:

It is recommended that:-

- the investment roll-up remain untaxed (4.5).
- the ability of an employer to claim a deduction in respect of contributions be limited on a "rand for rand" basis, which means that for every R1 contributed by employees the employer be entitled to contribute another R1 and claim it as a deduction from taxable income (4.12).
- self-employed persons be entitled to deduct 50% of their contributions (4.13).

9.4 Medical savings accounts; no and low claim bonuses:

It is recommended that:-

- a final withholding tax be imposed on interest credited to, and "cash withdrawals" from savings accounts offered by medical schemes, "cash withdrawals" being defined to include any payment (other than a transfer to another registered medical scheme) that is not for *bona fide* medical expenses of members and their dependants (4.17).
- bonuses paid to reward members of medical schemes for no or low claims be subjected to the same tax regime as "cash withdrawals" from medical savings accounts (4.18).

9.5 Para (c) benefit funds:

It is recommended that:-

- after a reasonable period of notice, the definition of "benefit fund" in the Income Tax Act be amended by the elimination of paragraph (c).

9.6 Amendments to Fourth and Seventh Schedules of the Income Tax Act:

It is recommended that:-

- the Fourth and Seventh Schedules be amended to ensure that employer contributions to benefit and/or retirement funds in excess of the limits provided elsewhere in the Act be allocated to individual employees on a basis satisfactory to the Commissioner and taxed in their hands through the PAYE and SITE systems (2.7).
- the definitions of "remuneration" in the Fourth Schedule and "taxable benefit" in the Seventh be amended to ensure that insurance premiums paid by employers on policies offering lump sum benefits to employees are fully captured (6.6).

9.7 Other amendments:

It is recommended that:-

- section 11 (*l*) be repeated in its entirety (2.9).
- the wording of paragraph (b) of the definition of "benefit fund" in section 1 and of section 18 (1) (a) be amended so as not to exclude statutory schemes or those registered in terms of legislation other than the Medical Schemes Act (4.19).

9.8 Monitoring of SITE system:

It is recommended that:-

- the SITE system be monitored on an on-going basis to detect any tendency that indicates a substantial increase in the number of applications for assessment on the grounds of medical expenses high enough to trigger deductibility; and that if this occurs section 18 of the Act be appropriately amended (4.9).

6th Report - BENEFIT FUNDS

CHAPTER 10 - ACKNOWLEDGEMENTS

10.1 Written submissions were received from:

Afrikaanse Handelsinstituut

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Business South Africa

Chamber of Mines Medical Aid Society

Chartered Accountants (SA) Medical Aid Fund

Mr W.B. Cronje

D & E Fund Administrators

Financial Services Board

Institute of Retirement Funds

Liberty Life

LOA Health Care Standing Committee

LOA Retirement Funds Standing Committee

Mathomo Group Ltd

Old Mutual Employee Benefits

Professional Provident Society of S.A.

Profmed

Representative Association of Medical Schemes

National Council of Trade Unions

S.A. Institute of Chartered Accountants

Sanlam

Southern Life

10.2 Oral evidence, on either a formal or an informal basis, was provided by:

Mr B Crookes Old Mutual Employee Benefits

Ms M Gottlieb Mediwise Marketing

Mr K Hanekom Old Mutual Employee Benefits

Mr G Hay Alexander Forbes

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Mr TJ Van Staden Mediwise Marketing

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10.3 The Commission would like to express particular appreciation for the support and advice received from a sub-committee comprising Professor G.L. Marx of the University of Pretoria, Mr F. Jooste of the Financial Services Board and Messrs J. Hanssen and J.D.V. Symington of the South African Revenue Service. Mr. D. M. Allwright served as Secretary to both the Commission and the sub-committee until April 1997, when he was succeeded by Mr W.J. Donachie.