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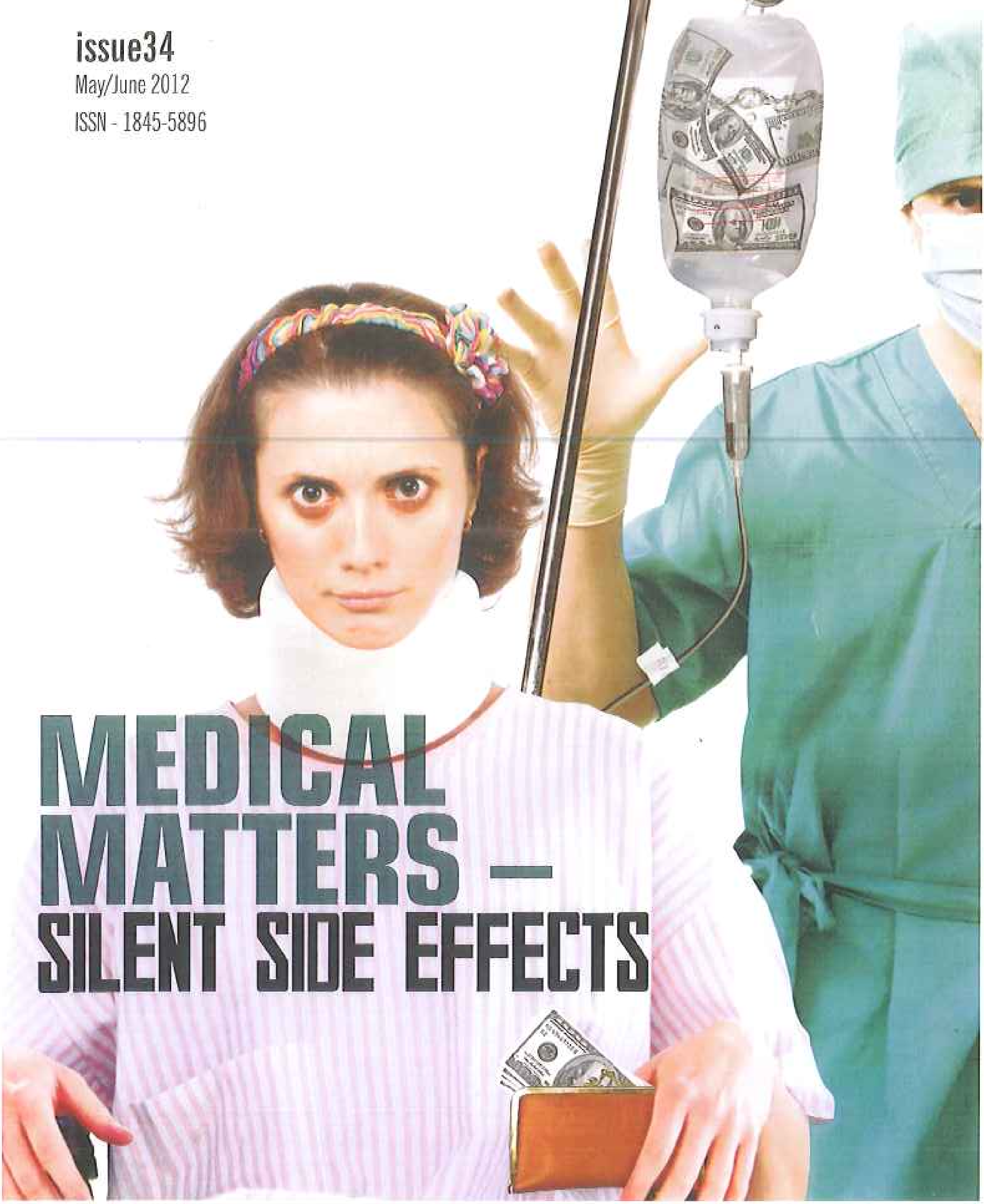
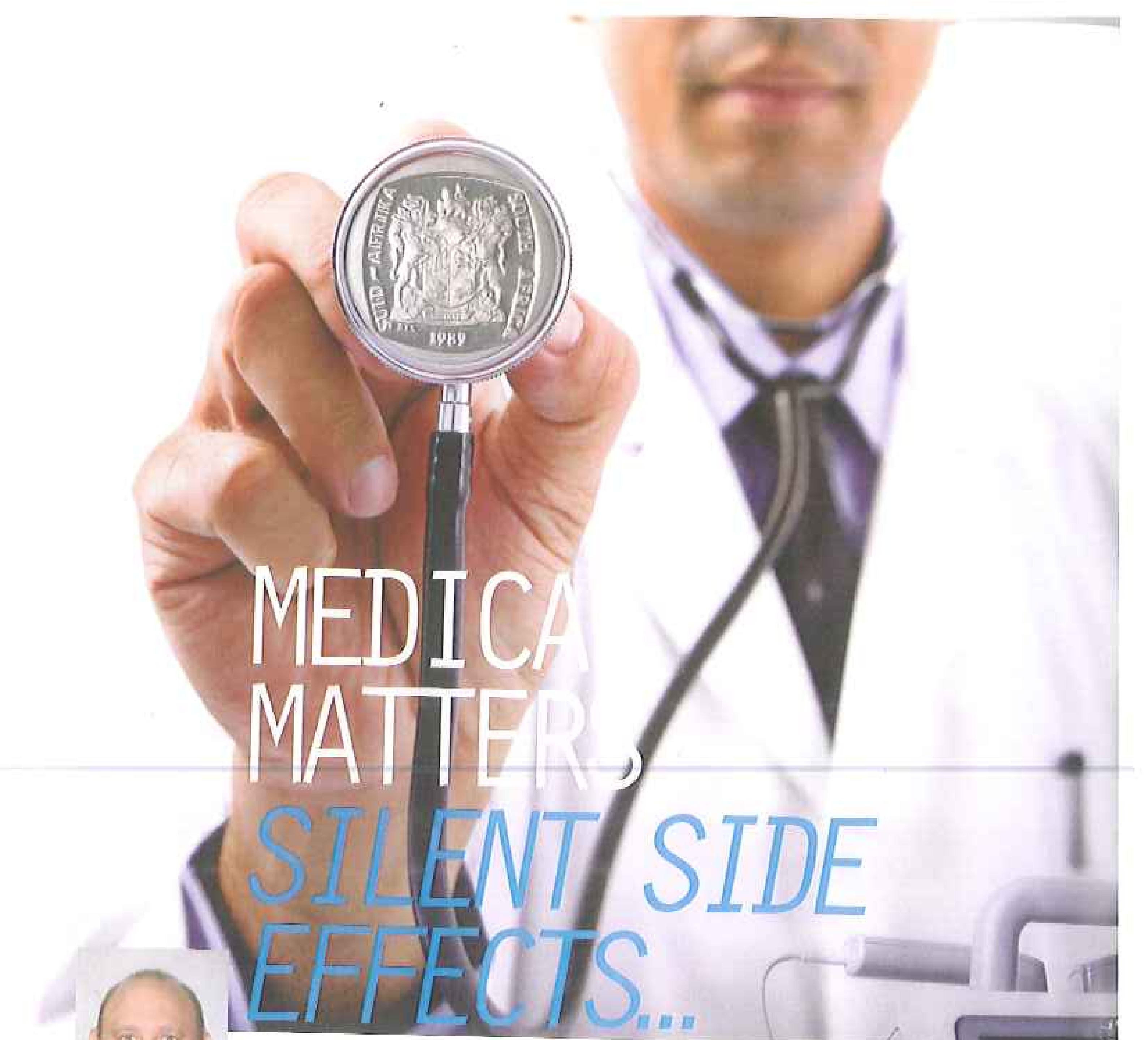


MEDICAL MATTERS – SILENT SIDE EFFECTS



MEDICAL MATTERS
SILENT SIDE EFFECTS...

BENDELS CONSULTING

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At the time of writing this article, the 2012 Budget is still hot off the press. It would thus seem logical that this article should commence with an analysis of the 2012 Budget. However, it is more beneficial to readers to discuss the 2011 Budget changes so that the 2012 proposals can be put into perspective.

2011 Budget changes

Two changes were promulgated, both of which became effective 1 March 2012.

1. Conversion of medical scheme contributions into tax credits.
2. Broadening the definition of 'dependant' for the purposes of section 18 of the Income Tax Act No. 58 of 1962, as amended. The change broadens the meaning for taxpayers to include immediate family members for whom they are liable for family care and support. For example, where siblings incur medical expenses for their sister who has a disability as defined in section 18(3) of The Act.

The amendment is rather tame, as it does not go far enough by including such a dependant in section 18(2)(b) (as the writer had suggested to The Minister of Finance) in order to allow the taxpayer to deduct all his or her medical expenses under section 18 of The Act. In other words the 7.5% capping still applies.

For the sake of brevity, therefore, no further discussion on this is deemed necessary herein.

> "To make matters even more complex, the law provides for the disability group to deduct the amount of medical aid contributions which exceeds four times the amount of the (section 6A) tax credit."

Conversion to tax credits

The conversion of medical scheme contributions into a rebate is known as the medical scheme fees tax credit (the tax credit). The law governing the application of the tax credit is set out in a section (section 6A of the Act) specifically inserted for this purpose.

The tax credit is non-refundable and is treated in the same way as the other rebates: namely, the primary rebate, the over 65 and the over 75 rebates. In other words, the insertion of the tax credit means that the act now has a quartet of rebates. A quintet of rebates/tax credits could be in force if the 2012 Budget proposals are promulgated, which is proposed to take effect from 1 March 2014. Is this the start of a large collection of rebates in our law? Will such conversion prove to be successful?

The amount of the tax credit for the 2013 tax year is:

i) R216 in respect of the benefits to the taxpayer.
ii) R432, in respect of benefits to the taxpayer and one dependant.
iii) R432, in respect of benefits to one taxpayer and one dependant, plus R144 in respect of benefits to each additional dependant, per month.

The rationale for the conversion of medical scheme contributions is that the tax credit applies equally to all taxpayers. The conversion to the tax credit is based on 30% of the amount of the tax deduction which would have been deductible in the absence of the conversion. It can be seen therefore that the conversion affects taxpayers paying tax at a marginal rate of 40% by 10%. By contrast, taxpayers with a marginal rate of 18% gain 12% as a consequence of the conversion to the tax credit at 30%.

An anomaly exists as the exception to the application of section 6A (i.e. the conversion to the tax credit) does not apply point for taxpayers over the age of 65. For taxpayers over the age of 65, therefore, the status quo remains that all medical scheme contributions are fully tax deductible. This contrasts to taxpayers who have a disability within the family.

This anomaly arises because the vulnerable group of disability taxpayers are not protected in the same way as those taxpayers over the age of 65. Prior to the conversion to the tax credit, the disability group was allowed to deduct its full medical aid contributions in the same way as taxpayers over the age of 65. Is it discrimination against the disability group? It is anomalies like these that creative tax planners thrive on. No doubt tax law advisers who specialise in the provision of tax law advice to the disability group will be kept busy in order to ensure that the playing field is equal between taxpayers over the age of 65 and the disability group.

To make matters even more complex, the law provides for the disability group to deduct the amount of medical aid contributions which exceeds four times the amount of the (section 6A) tax credit. Such deduction is made under section 18 of the Act and is thus not a rebate or tax credit.

There are three sets of taxpayers – those over the age of 65, the disability group and all other taxpayers. The treatment of the three groups is as follows:

Over 65 taxpayers do not obtain the tax credit but are allowed a deduction for all their medical aid contributions under section 18. In other words, there is no change for taxpayers over the age of 65.

The disability group receives the tax credit under section 6A as discussed above (thus 40% marginal tax rate taxpayers lose 10% under section 6A) and obtains a tax deduction under section 18 of the amount of medical aid contributions which exceeds four times the tax credit. This change will adversely affect many vulnerable taxpayers.

All other taxpayers – the amendment to the tax credit is as per section 6a. The excess of four times the tax credit of medical aid contributions (as for the disability group above) is relevant, however, such excess forms part of the overall deduction allowable under section 18 (i.e. "out-of-pocket expenses" – discussed below) i.e. the reasonably well known 7.5% "capping" rule applies. For the sake of brevity, therefore, the "capping" rule is not discussed herein.

2012 BUDGET PROPOSALS

Conversion of medical expense deductions

Most of the hype after the 2012 Budget proposals related to converting additional medical expense, or often known as out-of pocket expenses (OPE) deductions to tax credits with effect from 1 March 2014.

The rationale for the conversion is the same as that for the conversion of medical scheme contributions to the tax credit – to ensure improved equity.

For over 65s and the disability group of taxpayers, it is proposed that OPEs be converted to a tax credit at the rate of 33.3% and in addition medical scheme contributions in excess of three times the total allowable tax credits. (Page 52 of the Budget Review is the source of the above which explicitly includes the over 65 group of taxpayers.)

Are the complexities already showing signs that many adverse side effects will occur? The over 65 group of taxpayers does not receive the tax credit (under section 6A) so the reference to three times the tax credit is an unnecessary side effect?

For all other taxpayers, the conversion is proposed to be at the rate of 25%.

Apart from the negative impact the conversion will have on many taxpayers in the disability group whose marginal rate of tax is 40% (a 6.67% loss), there are many other concerns about the conversion of OPEs in their entirety. OPEs are also referred to as catastrophic expenses. (The National Treasury has used the word catastrophic in the past, for example Page 18 of The Tax Policy Discussion Document for Public Comment – on The Conversion of Medical Deductions to Medical Tax Credits – Issued 17 June 2011.)

The use of the word catastrophic is most pertinent when considering medical matters and assessing the efficacy of future tax laws, or otherwise. The side effects, or perhaps even considerable core effects, of the conversion to tax credits will prove to be severe, if not financially crippling.

To reiterate, the stated intention of the conversion to tax credits is to ensure increased equity of the tax system. It does not appear that sufficient attention has been made to the inevitable considerable increased inequity.

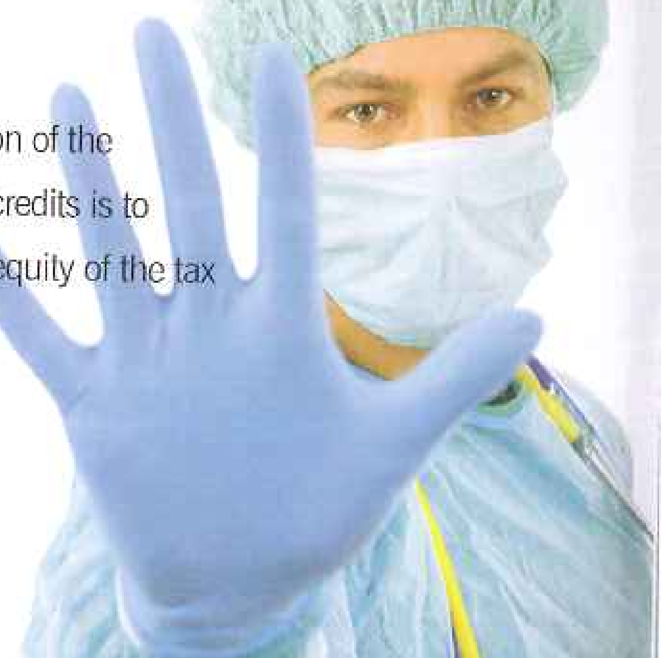
As referred to above, tax credits are not refundable and cannot be carried forward. In contrast, medical expense tax deductions under section 18 (as is currently the case) can and does create substantial tax refunds.

The writer's main concern with converting catastrophic expenses to non-refundable tax credits, or not being able to carry them forward to the following year of assessment, is that by their very nature they are unpredictable and can be substantial (for example, road accidents).

Take for example a taxpayer who has been fully tax complicit and has paid tax at a marginal rate of 40% for 25 years. Catastrophically, the taxpayer is unable to work for two years as he recovers from a serious road accident. It stands to reason that during such time the taxpayer would incur substantial OPEs. Assuming his OPEs during the two-year period are R1.5 million, the taxpayer will obtain no relief for his OPEs, or taxable loss of R1.5 million if the proposed conversion is promulgated. Seem fair and equitable?

In the absence of the conversion, the taxpayer would be able to carry forward the OPEs or his taxable loss by virtue of section 20 of the Act, which would shelter R1.5 million of his future income. This appears to be much fairer, in the writer's opinion, than the taxpayer losing R1.5 million because he has had a catastrophic accident and tax deductions are converted to tax credits.

The stated intention of the conversion to tax credits is to ensure increased equity of the tax system.



The conversion can and will create serious and substantial inequity in monetary terms to affected taxpayers. I would go even further and suggest that the Minister of Finance considers the position where losses may be carried back (1 – 3year) to the taxpayers prior-year of assessment. Carry back of losses is by no means unknown in tax jurisdictions around the world. The refund obtained from the carry back of the loss will allow the taxpayer to finance some of his OPEs. This seems fair to the taxpayer after all the tax he has paid over 25 years.

Would the conversion not be inequitable? How does the previously high earning taxpayer fund OPEs? The proposed conversion is likely to come under further close scrutiny before it is promulgated, if indeed it is. While the writer has focussed on a taxpayer paying tax at a marginal rate of 40%, the same could be said of 18% marginal tax rate taxpayers. Potentially could be even more financially "crippling" for such taxpayers as they may have no assets (such as ownership of a residential property) which they could sell to assist them to finance the exorbitant costs.

Special trusts

The Draft Taxation Laws Amendment Bill, issued on 13 March 2012, provides for amendments to be made to the definition, in section 1 of the Act, of 'special trusts' as contained in paragraphs (a) and (b) (section 1 of the Bill).

The only proposed amendment to a paragraph (b) special trust is the change of the age from 21 to 18. Accordingly, there is little change.

The major proposed change is to inter vivos special trusts as contained in paragraph (a) of the definition.

I have written and spoken at length about paragraph (a) special trusts and it came as no surprise that the definition has been amended by the deletion of subparagraphs (a)(i) and (a)(ii). The subparagraphs have been replaced by the insertion of the definition of a 'disability' in section 18(3). This is due to the fact that there was no alignment between the two subsections.

Since the two subsections refer to similar issues (i.e. disabilities), it would bring more symmetry to the legislation if the definition of section 18(3) replaced the existing subparagraphs. I alluded to this discrepancy in an article in 2010 (www.bendelsconsulting.co.za – Press Box: Tax and disabilities – how special are your trusts?). The suggested amendment was one of the budget tips that Bendels Consulting sent to the Minister of Finance.

As mentioned in a recent article in the TaxTalk newsletter (Special Trusts – Naturally Speaking? –http://www.taxtalkblog.com/?p=5943 we highlighted the fact that our top 2012 Budget Tip went unheard. So we can take little credit that the amendment to the definition of paragraph (a) special trusts is included in the Bill. (There may have been several tax law experts specialising in paragraph (a) special trusts who advised the Minister on this.)

It brings a whole new complex dimension to the drafting of paragraph (a) special trust deeds. Naturally, a deep knowledge of section 18(3) and its associated intricacies will be required. This is new ground for those Tax Law and other experts in this field who do not specialise in tax law and disabilities as contained in section 18(3).

What did come as a surprise, however, is the fact that paragraph (a) special trusts may be created for more than one person. Previously a special trust could be created only for a person (the singular providing the authority for that). If promulgated, broadly the trust can be created for more than one person provided that all persons are relatives. The proposal's intention is sound as it is not unknown, for example, for a family to have autistic triplets. To create a separate trust for each child adds unnecessary additional costs and administrative burdens.

About six months ago, I was asked whether a special trust could be created for three children. At that time, I said no. As time has passed, my opinion would be a rather different one as the changes to the definition of paragraph (a) special trusts came into operation as from 1 March 2012 (subject to promulgation).