MediFunder

The issue of pre-funding for post-retirement medical costs is a serious topic matter for both employers and employees to consider.

The cost of medical aid premiums, medical treatment and medicine has increased much faster than normal CPI (consumer price index) inflation in recent years and as a result, healthcare costs have almost doubled as a percentage of the business's payroll. This is resulting in employers moving away from traditional benefit structures where they were responsible for the extra costs for their staff towards a fixed package called cost-to-company. As businesses struggle to finance an ever-increasing medical bill, they have sought to peg their liability and transfer the responsibility for suitable provision to the employee him/her-self. If the business succeeds in doing so, it then becomes crucial for each employee to make adequate and timeous provision in order to pay his or her own medical scheme contributions and other costs while in retirement.

However, many businesses remain liable for these expenses on behalf of their pensioners. It is an accounting requirement that employers with such a liability disclose this in their financial statements. Employers either need to fund such a liability by way of a suitable investment or to negotiate a settlement with the employees to remove it from the balance sheet.

The need

For the employer there is a need to structure suitable investment/s to house the financial provisions required to fund the liability adequately. In addition, where the employer does not have a liability but still wishes to assist staff in making adequate provision, either financially or administratively, suitable investment vehicles are also required.

The solution

One must bear in mind that there is no single product that will be suitable for all clients. There is also no right or wrong investment but merely the most appropriate one, or more.

Implementation

Before determining the best solution, the following factors must be considered:

- Ownership
- Control and choice of funds
- Accessibility at retirement
- Liquidity (vesting scale)
- Tax deductibility
- Costs vs. benefits
- Payment method and administration
- Term

While tax may be an important consideration for employers when choosing solutions, the South African Revenue Service (SARS) has not yet approved any one product to be used for the pre-funding of post-retirement medical costs though it has indicated that retirement funds are 'well suited' for this purpose.

1. Employer-funded schemes

A cell-captive

A cell-captive insurer is a registered long-term insurer that has permission from the Financial Services Board (FSB) to issue preference shares or a special class of ordinary shares to clients. The long-term cell-insurer issues an insurance contract for each cell and the owner of the shares is entitled to participate in the insurance business that is con ducted in respect of the contract/s. Through the cell-captive, cell owners benefit from conducting their own insurance business in a scenario where the long-term cell insurer undertakes the administration, statutory reporting and legislative responsibility. This eliminates the need for the cell owner to set up these structures. An example is where a life annuity is bought for a retiring employee with the maturity proceeds of an investment. If the employee dies a week later, the annuity would immediately stop and the long-term insurer would benefit substantially. The cell owner (the employer) would then share in this profit. Conversely, the cell owner also shares in the risk of the pensioner's sustained longevity. This solution is usually most suitable for larger employers who have existing pensioners.

Sinking funds

This is a very simple solution that is owned and paid for by the employer and is reflected as an asset on the balance sheet to offset the pre-funding liability. Contributions to a sinking fund are not tax deductible but the advantage is that no income tax will be paid on the proceeds. They are issued by a long- term insurance company but are not required to have an insured life and are therefore not linked to any one employee.

Pension and provident funds

Pension and provident funds are normally considered suitable as a pre-funding investment due to the tax deduction options available to employers. In addition, should the employee contribute to the fund, he/she will also qualify for a tax deduction if a pension fund rather than a provident fund is used. When the employee reaches retirement age, the capital can be used to purchase an annuity providing an income for his/her life. The additional income will be tax- able but if the employee is over the age of 65 years, he/she qualifies for an unlimited deduction for every rand spent on medical expenses. The problem is that there is a limit of 20% for employer tax deductions that may already have been reached.

In addition, the employer will not be able to get back any of his/her contributions to the fund, as they belong to the member.

Preferred compensation scheme

The employer can implement a preferred compensation scheme to benefit employees who remain in their service until retirement age.

The employee effects an endowment policy on his/her own life. The employer increases the employee's remuneration to allow for the payment of the full premium, with after-tax funds.

The employer enters into a service agreement with the employee whereby the employer agrees to fund the policy until the retirement age of the employee. The policy, which is owned by the employee, is ceded to the employer as security until retirement age. The employer is contractually bound to cancel this cession upon the employee reaching the retirement age.

At retirement age, the employee will retain full ownership of the endowment policy and can invest it to provide a monthly income to fund the medical scheme contributions. Where the policy matures the proceeds will also be payable to the employee tax-free.

If the employee does not remain in the employment of the employer, the employer will be entitled to retain the policy in terms of the security cession. The employer will be entitled to the proceeds of the policy and the proceeds will be payable to the employer tax-free.

It is important to remember that an increase in salary will increase the taxable income of the employee. Therefore, the tax implication on this increase should be taken into account to ensure that the net increase is sufficient to cover the contribution to the endowment.

The following example will illustrate the point:

Status Quo:

Assume that the employee earns a current gross income of R12 000. The tax payable will be R3 000 per month resulting in a net salary of R9 000 per month (marginal tax rate of 25%, ignoring any rebates).

Negative scenario:

If it is assumed that the premium on the policy is R1 000 per month and the employer only increases the salary by this amount, the tax payable will be R3 250 per month, resulting in a net salary of R9 750 per month. After paying the premium on the policy the actual net income will amount to R8 750, which is R250 less than the employee received previously..

It is important to maintain the employee's financial position compared to what he/she earned prior to the implementation of the scheme. To achieve this, the tax on the increase has to be taken into account. Therefore, as the marginal tax rate of the employee is 25%, the increase has to be R1 334 (premium required divided by 100% less marginal tax rate).

Positive scenario:

The total gross income is R13 334 and the tax amounts to R3 334. The net salary is R10 000, minus the premium of R1 000, calculates the employee's net income, after tax, as being R9 000, equal to the income that the employee received prior to the implementation of the scheme.

The salary increase paid by the employer will be tax deductible under section 11(a) of the Income Tax Act for the employer. The salary increase will be included in the gross income of the employee and will be taxable. The premium paid into the endowment policy will not be tax deductible.

As the policy is funded with "after tax" funds, the proceeds will always pay out tax-free.

There is also no capital gains tax payable. The Eight Schedule to the Income Tax Act provides for an exclusion of long-term insurance policies payable to the original beneficial owner. This is inclusive of his or her nominee/spouse and will also apply if payable to a cessionary in the case of a security cession.

2. Employee-funded schemes

Corporate retirement annuities

Individual retirement annuities are a tax-effective method of pre-funding for post-retirement medical expenses. The reasons are:

- Individual contracts can be linked together under a scheme for administration and control purposes;
- They can be customised to match each employee's needs;
- They are portable and move with the employee independently of his/her employment;
- They are flexible and can be altered during the term to adapt to changing circumstances;
- They allow the employee to decide when the benefits are required at any time after the age of 55; and
- On retirement, a Corporate Retirement Annuity contract forces the employee to purchase an income for life. Although the income is taxable, the income used to pay monthly medical costs will be tax deductible after age 65. The employee is ensured of paying no unnecessary tax.

The Income Tax Act currently allows taxpayers a deduction for retirement annuity contributions within certain limits. These limits are:

- 15% of non-retirement-funding income, or
- R3 500, less deductible pension fund contributions; or
- R1 750, whichever is greatest.

Where the required contribution for pre-funding purposes exceeds the maximum tax-deductible amount that may be contributed to a retirement annuity, the employee can either look at other discretionary investments for the excess or can pay additional contributions to the retirement annuity as these can be withdrawn tax-free at retirement.

Pure endowments

This is probably the most simplistic method of pre-funding as no income tax considerations need to be taken into account. The contributions do not qualify for a tax deduction but the proceeds are then available tax-free to the owner in terms of current legislation. In addition, where the original owner withdraws the proceeds, the amount is also exempt from capital gains tax. The result is flexibility for employees to use the capital as he/she requires at all stages during their retirement. The employer does not prescribe how the capital should be used but may be concerned that it could be squandered and not used to pay medical expenses.

Unit trusts

Should the employee have fewer than 5 years towards their retirement age, or should either the employee or employer prefer the flexibility and choice of funds available through the collective investment (previously called the unit trust) industry, this is also a viable option.