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HSAs In Canada – The Trend Towards DC-style Benefit Programs

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In the **pension** world, every plan sponsor understands the rationale of moving from a **Defined Benefit** to a **Defined Contribution** model. While the debate over **DC plans** began in the 1960s, their mass adoption as a **pension** model truly ramped up in the 1990s as taxation rules changed and new technology was introduced to facilitate delivery and choice selection to larger employee groups.

While the **DC** model has been easily adopted by **pension plan sponsors**, only recently has the model started to gain popularity for the delivery of **group health benefits**.

For years, **group health benefits** have been tied to a **defined plan** design. Whether fully insured, or using an **administrative** service only (ASO) model, **group health plans** have always been controlled by a defined set of limits and **benefits**. With the rising costs of prescription drugs, the de-listing of services from the provincial governments, and a greater acceptance of paramedical services among employees, plan sponsors have been forced to modify their plan designs to control costs. In some cases, this has involved a reduction in annual limits, co-pay programs, or the implementation of tighter maximums.

For others, it has involved the removal of coverage from the plan or complete abandonment – a major source of friction between employers and employees. Only recently has a third option emerged, the movement towards a **DC** model for delivering **group health benefits**.

Funding Solution

In 1986, then-Finance Minister Paul Martin introduced a new funding solution for incorporated entities to provide health benefits. Outlined in a bulletin from Canada Revenue Agency (IT- 85R2), the concept for the Health and Welfare Trust (HWT) was born. In essence, the bulletin allowed Canadian corporations to deposit funds into a trust account for the tax-free benefit of an arm's length designated recipient, such as employees, and claim the contribution as a business expense for the corporation. A third-party trustee was required to manage the trust. A few years later, after pressure from non-incorporated businesses, the government introduced another bulletin (IT-339R2) and the Private Health Services Plan (PHSP) was introduced.

A major benefit of the HWT and PHSP – flexibility in spending – took a back seat to tax savings for many years. Both funding models offer the same tax-deductible benefits for the contributor, however, the PHSP has limits in terms of annual contribution amounts and fund forfeiture after 24 months of initial deposit. In spite of these differences, both models have been intertwined in recent years as a common group benefits model, the Health Spending Account or HSA.

The HSA landed on the vocabulary of every plan sponsor when the 'flex benefits' model began to roll into every major company in Canada. Overnight, more and more companies started to offer a flexible range of plan designs where employees could purchase benefits using a credit or unfunded system. Eventually, RRSPs and HSAs appeared as 'bank accounts' for an employee to deposit unspent credits. For many employees, the HSA was an excellent option for depositing excess credits to be used for health costs exceeding the limits of the plan design. Over time, employers started to offer HSAs as a retention tool for senior management above and beyond their traditional group benefits program.

'Total Compensation' Trend

As the 'total compensation' trend kicked into high-gear after Y2K, many plan sponsors found this to be an excellent vehicle for adding compensation without it bearing a taxable burden on the company or the employee.

However, in the past three years, activities in the United States have brought the HSA to the forefront as a core solution for delivering group health benefits. In the U.S., the HSA is referred to as a Health 'Savings' Account, with the difference in name being just the beginning in comparison to its Canadian counterpart.

First off, the HSA in the U.S. acts like a true savings vehicle open to individual consumers with contributions being taxfree. However, the funds can accumulate interest, unlike the Canadian model. The major difference is the requirement of a high-deductible insurance product to complement the account. The annual amount an individual can deposit into their HSA and claim as a tax deduction is based on the greater of the annual insurance deductible, up to a maximum of \$2,700 per single and \$5,450 per family. The owner of the HSA can invest the funds. However, the account must be their only source of insurance. This is a new concept in the U.S., first started in 1996 with the establishment of Medical Savings Accounts, followed by Health Reimbursement Accounts (HRAs) by the IRS in 2002. However, the real catalyst for the recent activity was the passage in 2003 of the Medicare Modernization Act.

Since 2003, the HSA has been a front page news item in the U.S. with many companies jumping aboard. In a country where the cost of healthcare is a speeding train with no brakes, many corporations have come to a crossing point due to the pressure the plans have placed on profitability and shareholder confidence. This has given rise to a growing number of companies moving towards the DC model for their group health benefits program, with the mechanism being the HSA.

In the past two years, U.S. companies have been giving their employees more of a stake in their healthcare spending with the hope that they will make wiser, price-sensitive choices in their spending. To date, companies such as Microsoft, Fujitsu Ltd., General Motors, Nokia, and Daimler Chrysler have implemented the DC model for their U.S.-based employees through an HSA.

Budget Certainty

The model has allowed the employer to offer a benefit to their employees while achieving budget certainty. With many HR managers using a percentage of payroll versus head count for budgeting, the defined HSA contribution amount is the first standard outside of the traditional group insurance premium suitable for budgeting. However, unlike insurance premiums, the HSA contribution can be fixed by the employer, not an insurance provider. By passing the cost of the high-deductible insurance to the employee, U.S. employers can control their benefit costs through the defined annual contribution they budget for their employee's HSA. The decision power and control of the benefit is now in the hands of the employee allowing the employer to complete their obligation in delivering the benefit without direct liability for the performance of the plan and coverage.

For U.S. employees, the benefits are numerous. The main advantage of a highdeductible insurance plan is that it reduces, in most cases, the monthly premiums paid by the employee. Many U.S. employers offer it to their employees as a lower-cost option to comprehensive insurance.

For the HSA, the advantage is the tax savings. In the U.S., the money can be invested and grow tax-free. Considering the funds are tax-free to withdraw for eligible medical expenses, many analysts have stated that the HSA is superior to a 401(k). Since the U.S. model is designed to act as a long-term savings vehicle, the HSA can be funded to cover post-retirement health benefits.

Back in Canada, the model is very different. In the past, the growth of HSAs has focused primarily on unfunded credits or cost-plus hybrids. Only recently has the Health and Welfare Trust or HWT started to gain momentum.

The issue for many HSA plans on the market today is funding. Currently, CRA advises that "contributions to the fund must not exceed the amounts required to provide these benefits. Furthermore, the payments by the employer cannot be made on a voluntary or gratuitous basis."

An actuarial study can facilitate overfunding over a given time horizon, provided it demonstrates the need for the funds to cover costs in the future. Unfortunately, many unfunded cost-plus products have surfaced in the past 10 years marketed as PHSPs or HSAs. It is the skepticism of cost-plus by the accounting and HR professionals in Canada that has seen more and more employers moving towards the HWT model.

The key benefits of the HWT for the employer are the fixed contribution amount and budget certainty. The HWT is an excellent alternative for the employer faced with rising insurance premiums, lower employee appreciation, and a desire to be an employer of choice in their industry. The employer can fund the employee's HWT at a fixed amount each year and increase contributions annually along with inflation or a defined tier of compensation classes unique to their organization. Since CRA stipulates that the funds can never revert back to the employer, most employers choose to fund the HWT on a monthly basis to promote employee retention.

Greater Choice

For the employee, the HWT provides a tax-free benefit and greater choice in where they spend their healthcare dollars. For those employees looking for added security for the unforeseen, the funds in the HSA can be used to pay premiums to a group insurance plan, similar to the U.S. model.

The current Canadian model provides many of the same benefits as its U.S. counterpart. With the growing concern among Canadian employers regarding increasing drug costs, budget certainty, and employee retention, health benefit programs will continue to be a growing issue of concern in the coming years. To accommodate fiscal and employee obligations, more and more employers will move towards the funded health and welfare trust as a core solution to facilitate greater cost-control, obtain budget certainty, and increased appreciation from employees for their plan. ■

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