

SEPARATE BUT NOT EQUAL

HCSAs aren't all the same...
investigate what's right for
your plan

By **James Geneau**

With any financial product, a lack of industry standardization often causes confusion within the marketplace. No product within the benefits market today could be more subject to such confusion than the healthcare spending account (HCSA). Over the past 10 years, this non-taxable health benefits bank account has grown to become a popular tool in creating a total benefits solution for Canadian companies. However, different rules have been a source of frustration when trying to design the right plan for an organization's unique needs. When it comes to the world of HCSAs, it turns out that the old *Sesame Street* vignette "One of these things is not like the other" is applicable. Let's take a closer look.

A History of Interpretation

The first HCSA in Canada can be traced back to the health and welfare trust (HWT), a concept first introduced in 1986. The notion of the HWT—set out by the Canada Revenue Agency (CRA) in its interpretation bulletin IT-85R2, "Health & Welfare Trusts for Employees"—provided the first-ever savings model for health expenditures in Canada.

During the remainder of the 1980s, a

series of supporting IT-bulletins was released almost annually, each providing different specific guidelines for a set audience or business application. Over time, these bulletins would become viewed as a series of user manuals for designing an HCSA. As a result, several hybrid plans exist in the market today that are labelled as HCSAs, private health services plans (PHSPs), HWTs or health savings accounts. Rules for managing the account set at the administrator or insurer level have added another layer of confusion for brokers, advisors, consultants, employers and employees.

In order to understand the HCSA options available, it helps to look at the original IT-bulletins, their rules and the audience they were designed for. Following are three core types of non-taxable HCSA, each with its own rules and applications.

Primary HCSA Designs

1. Notional Credit or Allowance-based HCSAs – Most Canadians are familiar with this form of HCSA. Offered primarily through insurance companies, the HCSA is traditionally incorporated into a flexible or cafeteria-style benefits plan. This plan was introduced by the CRA as part of the rules outlined in IT-529, "Flexible Employee Benefit Programs."

While some plans have restrictions in terms of coverage and eligibility, most

allow for anything outlined by the CRA in IT-519R2, "Medical Expense and Disability Tax Credits and Attendant Care Expense Deduction." This bulletin provides a list of eligible medical expenses that employees may claim as part of the personal medical tax credit and is universally viewed as the guideline for what is considered an acceptable medical expense from an HCSA in Canada.

With these plans, the employer either pays a premium to the insurer for a predefined amount of bulk coverage or reserves funds for possible expenditures as incurred. This model allows an employee to deposit any leftover funds or credits from his or her flex plan into an HCSA after selecting a core health coverage option. The majority of these plans follow the rules for a PHSP, where every dollar deposited expires after 24 months and, if not used, is forfeited.

The forfeiture of unused funds by the employee results in one of two scenarios, depending on the set-up by the employer, insurer, third-party administrator or consultant. If it's a notional credit model, the funds may return to the employer as a credit to the account. If it's a budgeted allowance in the plan, the amount is included into the overall premium charged by the insurer, and any unused amounts are simply considered unpaid claims by the insurer.

2. PHSPs – PHSPs are widely used to describe any private plan provided by a company to fund health benefits for its employees. However, some providers do offer a PHSP as a stand-alone product, following the rules outlined in IT-339R2, "Meaning of Private Health Services Plan."

These plans are designed for privately held and unincorporated companies, and they have more stringent rules for contributions, fund rollover and deductions. The major difference with a PHSP is the contribution maximums: the annual contribution is limited to \$1,500 per sole proprietor; \$1,500 per dependent *over* 18 years of age; and \$750 per dependent *under* 18 years of age.

The start date of the plan also limits the amount that the company can deduct as a business expense. Contributions are pro-rated based on the tax year, meaning that a plan starting midway through the year would be allowed to claim only 50% of the contribution. Further, the funds may only be used for 24 months from the date of deposit. If the funds are not used, they are forfeited—in many cases, to the third party offering the PHSP.

A sole proprietor of a company can establish a PHSP with a third-party for himself or herself and family members. If proprietors have employees, they would need to offer themselves the same level of benefits as the lowest amount received by one of their employees. Further, they must offer an HWT to the employees and a PHSP for themselves as owners. This is a major reason why smaller companies choose to incorporate and take advantage of an HWT.

3. HWTs – The HWT is probably the most basic of the HCSAs in terms of design. The HWT is a contract established by the employer with the employee, which often involves a third party to establish the trust account, manage the funds and

FAQs ON HCSAs

Answers to the top questions from brokers, consultants, employers and employees

CAN AN HCSA BE USED AS A TAX-FREE INCENTIVE FOR EMPLOYEE RETENTION AND REWARD STRATEGIES?

Absolutely. The health and welfare trust (HWT) is probably the best form of healthcare savings account (HCSA) in terms of offering benefits for both the employee and the employer, tax-wise. For the employee, the funds are a tax-free benefit, and if they are received as a bonus in addition to the employee's base compensation, they have no impact on his or her overall taxable income for a given year. For the employer, the funds are a business deduction, and the amount is not subject to the same payroll deductions as cash-based compensation.

WHY DO SOME PLANS COVER GYM MEMBERSHIPS AND ATHLETIC APPAREL?

In order to promote greater health and wellness among their employees, some companies offer an allowance for employees to expense items that are not considered an eligible medical expense by the Canada Revenue Agency. These "allowance" accounts are great for helping to promote healthier lifestyles but are not HCSAs in the context of acting as a vehicle to deliver tax-free benefits.

HOW ARE PROVINCIAL AND FEDERAL SALES TAXES APPLIED TO HCSAs?

This depends on the type of HCSA, the provider and the provincial rules. Most stand-alone HCSAs offered either as a private health services plan or as an HWT are charged an administrative fee by the third-party provider. This is normally a percentage of the amount being deposited, ranging from 10% to 13%, and is a deductible expense for the employer. These administrative fees are taxable at varying levels across the country, from GST-only on the fee (Alberta), to HST plus applicable premium taxes on both the fee and the deposit (Ontario).

WHAT ARE ACCESS FEES, AND WHY DO SOME HCSA PROVIDERS CHARGE THEM?

The third party is not required to charge access fees; in many cases, they are simply a tool for managing certain costs above and beyond the administrative fee. Like the administrative fee, they are an eligible expense from the HCSA. And, like the fees that different banks charge, there are several options available in the marketplace, so employers should do a cost study before selecting a provider.

CAN A COMPANY USE AN HCSA AS ITS SOLE HEALTH BENEFITS OFFERING?

Yes, although it's not advised. The HCSA is a great tool for covering predictable claims, and employees can use the funds to reimburse the cost of premiums for catastrophic group drug and dental plans. However, relying on employees to purchase their own coverage is risky. An employer should always rely on the security of a traditional insurance-based drug plan for unforeseen or catastrophic events and offer an HCSA for predictable claims or to provide additional coverage.

WHAT HAPPENS TO THE FUNDS IN AN HWT IN THE EVENT OF AN EMPLOYEE'S DEATH?

The funds are held in trust for the beneficiary, and the registered dependents would be allowed to make claims until the funds in the account are depleted. However, the sponsoring company would cease making any contributions and would be able to justify them as a business expense upon the employee's death.

adjudicate the claims. The employer funds the trust account and can deduct the deposits as a business expense.

The employer must be an incorporated entity, and the contribution is a business expense, provided that it is offered to all employees and not exclusively to shareholders. The amount the employee receives is a tax-free benefit if he or she resides outside of Quebec, where different tax rules for benefits apply.

The funds remain in trust for the employee to use exclusively for eligible medical expenses and never expire. An employee can use the funds as he or she incurs an expense or can save the funds for the future. Further, the funds may be used to cover expenses incurred by any relative of Canadian citizenship and residence through blood or marriage, regardless of age, who is financially dependent on the employee within a given tax year. There is no limit on the amount that a company can deposit into the HWT for an employee; however, the amount must not exceed the amounts required to provide reasonable benefits and can never be returned to the employer.


As with the other HCSA plans, the contribution amount is an annual declaration and cannot be amended during the 12-month policy year unless there is a life change (i.e., change in dependent requirement—birth, death or addition of a dependent) within the employee's household. In addition, the trustee or third party responsible for managing the account can enforce the employer to fulfill its contribution requirements for the trust.

Hybrid Plans, Cost-plus and Managing Risk

While HWTs, PHSPs and notional credit or allowance-based HCSAs are considered the core types of HCSA, there is another group whose plan designs are hybrids of these core plans and include cost-plus. With these options, some providers have taken select rules from each of the core offerings to create a different product that is more palatable to the market.

Many of these plans have been designed using the most convenient features outlined in each IT-bulletin to create a more "sellable" HCSA. While

many are technically in line with the rules outlined by the CRA, HR managers should always seek guidance from an accounting professional or consultant before making a decision on a specific product. Since the CRA's bulletins are interpretations and not the law, the best advice is to adopt an HCSA program that follows the guidelines within these interpretation bulletins as stringently as possible. This reduces the risk associated with being offside, should the CRA question the HCSA that the company has chosen and whether the expenses are a legitimate business deduction.

As a general rule, if the plan offered resembles one of the three core plans, then it is a lower-risk investment. If there are questions on the rules outlined in the bulletins and their application to a specific HCSA product, chances are that the risk is too high and you should pursue a more conservative plan. 

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