FINANCIAL PLANNING II

DESPITE RISING COSTS
There is a creative option for employee health care

By PETER MERRICK and STAN RISEN

Traditionally, small to mid-sized Canadian businesses have offered group health benefits to their workforces by utilizing insurance carriers. During the last decade, consolidation in the market has resulted in fewer carriers within the insurance industry, limiting the choice for the Canadian employer.

Benefit plan sponsors generally assume that the responsibility of health and dental claims will be taken on by their insurance providers in exchange for paying a premium. Upon closer review of the average group health benefits policy for small to mid-size businesses, only 65 per cent of the overall premiums are earmarked to be paid out for eligible claims. The remaining portion pays administrative costs, covers unforeseen risks, commissions and insurance carrier profits.

The cost of health care in Canada is growing by at least 15 per cent per year. It is widely believed that our aging population, the de-listing of government funded services, rising costs for pharmaceuticals, and new appreciation for alternative therapies are driving these costs.

In response, employers have tried to curtail these expenses by introducing annual limits, co-insurance, deductibles and exclusions to their health and dental plans. This has been a major source of friction between employers and employees. If you are a business owner, you probably already feel the pain, but think you have no options. If you are the business adviser or the external accountant, you can now suggest an affordable solution.

MERRICK

RISEN

As an alternative to traditional group insurance for health and dental, innovative companies are choosing a self-insurance or administrative services only (ASO) model. With ASO, the employer assumes the cost of all claims paid as per an established plan design.

In order for the Canada Revenue Agency to allow the cost for health and dental claims to be tax deductible for the employer, and the benefits to be non-taxable for employees, the administration of these plans must be handled by a third party.

With the ASO model when an employee incurs $600 of annual claims for health and $800 for dental (average spending), the entire cost is borne by the employer. But what if an employee has a large drug claim or hospital claim? Can the plan sponsor afford the risk of self-insurance?

To reduce the likelihood of incurring a significant claim from an employee, insurance is still a wise purchase. Statistically, most employees spend less than $1,000 on eligible health claims.

Therefore, the premium for insurance over this amount is reasonably affordable. In this case, insurance is truly insurance. The company is assuming the cost of predictable claims, and purchases insurance for the catastrophic risk of unpredictable large claims. This type of insurance is referred to as stop-loss insurance.

For companies with less than 150 employees, the key factor is selecting the appropriate stop-loss level. As the deductible or stop-loss level increases the corresponding premium is reduced. However, the level of risk increases should the company incur a major claim.

Regardless of the cost of the stop-loss insurance, the company will only tolerate a certain level of risk.The key is understanding claims activity and choosing a level of stop-loss insurance at which the risk tolerance and savings are in harmony.

To illustrate the savings from the ASO model with stop-loss insurance, we will use a 10-employee company. The total health claims for the previous 12 months were $9,000 and the total dental claims were $7,000.

Traditional Insurance	
Health premiums	$13,000
Dental premiums	$11,000
Total cost	$24,000

ASO with stop-loss ($1,000 level)	
Health claims	$3,800*
Dental claims	$7,000**
Stop-loss premium	$6,000
Administrative cost	$1,680
Total cost	$18,480
Saving	$5,520 (23 per cent)

* As a rule of thumb, 80 per cent of all claims come from 20 per cent of all employees – in this scenario, two employees incurred $3,600 worth of health claims each, costing the stop-loss carrier $2,600 per employee based on a $1,000 stop-loss deducible. Deduct that cost from the initial $9,000 and $3,800 is borne by the company.

** The dental claims are fully self-insured by the company and will cost the company the full $7,000. There is no stop-loss for dental. Unlike health, that could have a catastrophic event, dental has built-in limits of coverage and therefore there is no need for dental stop-loss insurance.

For companies with less than 150 employees, the key factor is selecting the appropriate stop-loss level.

In the example, the company would save $5,520, or 23 per cent, by converting to a self-insurance model with a stop-loss policy. In the worst-case scenario that all employees have high health claims one year, the company's exposure is still capped at $1,000 stop-loss level per employee and therefore, the health claims would increase from $3,800 to $10,000 – an increase of $6,200. There would also be an additional administration cost of $620. If this was the case, the total cost for that year would be $25,300.

However, while the likelihood of such an event occurring is extremely minimal, the impact on the following year with ASO would still be less than with traditional insurance that reimburses from the first dollar.

The cost of ASO is claim-driven and therefore employers need to review their plan designs and understand where employee spending is occurring. A good third-party administrator will report all claims (drug, dental, paramedical, hospital, vision) to the employer. The insurance holders' names should never be disclosed due to federal privacy laws. With this information, employers together with their administrators are equipped to respond to increasing health and dental costs.

Peter Merrick, BA, FMA, CFP, FCSI is the president of Merrick Wealth Management Inc. a fee-for-service financial planning and benefit consulting firm in Toronto. He can be contacted at peter@merrickwealth.com or 416-854-1776 or www.merrickwealth.com.

Stan Risen, CA,is the vice-president of sales and consulting for Benecaid, a Canadian financial services company focused on delivery and administration of leading-edge employee benefit solutions.

Professional advice key in proper estate planning

Continued from page 14

Taxes can be deferred two decades

Tax on the future growth of assets transferred to a family trust can only be deferred by up to 21 years if the assets are to remain in the trust. This is because family trusts are deemed to dispose of their assets at fair market value every 21 years. Therefore, any accrued gain on property held by the trust will be taxed at the top marginal rate for capital gains if the asset has not been distributed to the beneficiaries.

If the trust deed allows the trustees to distribute the assets to the beneficiaries prior to the 21st anniversary, it may be possible to roll out the assets at their adjusted cost base to defer the capital gains tax either until the beneficiary sells the assets, or on his or her death.

This rollout is not available to a beneficiary who is not a resident of Canada. If someone is considering including a U.S. citizen or resident as a beneficiary, they should seek professional advice on both sides of the border first.

Assets held in a family trust will be protected from the creditors of the beneficiaries and should not form part of their family assets for family law purposes, even after distribution from the family trust.

It is possible to defer the capital gain realized on the deemed disposition on death by transferring assets to either a spouse or a qualifying testamentary spouse trust, which would be created upon death. In this case, the tax on this capital gain will be deferred until the earlier of the assets being sold and the death of their spouse. The rollover to a spouse trust will only apply if no one other than the spouse is entitled to all the income of the trust and the spouse is the only discretionary capital beneficiary during his or her lifetime.

A testamentary spouse trust also allows an individual to control entitlement of the assets after the death of their spouse.If instead the assets are transferred directly to the spouse, it is the spouse's will that directs the distribution of the family assets. Spouse trusts and any other testamentary trusts (which must be created by the individual's will) are taxed as a separate taxpayer and subject to the graduated personal tax rates.

As a result, it is possible to income split by having some of the income taxed in the testamentary trust and some taxed in the beneficiary's hands. Access to this additional set of graduated rates can result in a tax saving of approximately $10,000 per year, per trust.

Spouse trusts (testamentary or inter vivos) can exist for the life of the spouse; assets are deemed disposed of on the spouse's death, rather than every 21 years.

Insurance benefits tax free

An estate freeze will allow you to predetermine the tax liability on death in relation to the frozen assets. Once this liability has been estimated, individuals should consider whether their estate will have sufficient assets to fund the tax and enough left over to support any dependents or satisfy charitable intentions. If they determine that they will not have sufficient assets, they can consider purchasing life insurance to provide additional funds. Insurance proceeds are received by the individual's estate or beneficiaries tax free.

If the intention is to defer the tax liability until the death of the surviving spouse, consider last-to-die insurance, to reduce premiums during the individual's lifetime.

Depending on circumstances and mortality rates, life insurance premiums could end up costing more than the ultimate tax being funded, so ensure that insurance is indeed the most efficient way to fund the ultimate tax liability. It is always prudent to review insurance needs every few years to ensure the right amount of coverage is being carried.

If an individual has not attended to their estate plan or if it needs to be reviewed to ensure all intentions will still be met under the current situation, they should contact a professional tax adviser.

Teresa Gombita, CA is a tax senior manager with Ernst & Young LLP with 20 years experience in tax preparation and consultation. She has specialized in personalized strategies to help high net worth individuals, business owners, executives and trusts reduce their current and future income tax burdens. She can be reached at teresa.gombita@ca.ey.com or 416-943-3272.