

Commercial Insurance Update

Topics Affecting Buyers of Commercial Insurance

MSP C 04/2003 – “Employee Benefits: Defined Contribution Plans vs. Cafeteria Plans”

April, 2003

Employee Benefits: Defined Contribution Plans (HRAs) vs. Section 125 Cafeteria Plans

As the cost of health care rapidly increases, many employers are faced with a new dilemma—how to offset these costs. **Defined contribution plans** have been growing in momentum for the past couple of years. Employers are also concerned with more state and federal mandates that fuel premium increases, and with potential legislation that increases employer liability and potential litigation. Employers are looking at alternatives.

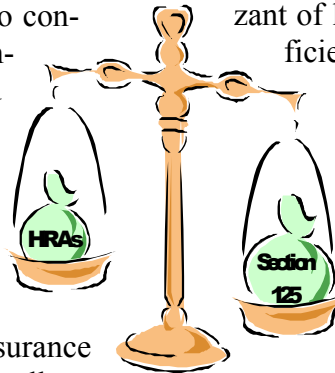
Defined contribution plans may be as simple as an employer paying a set dollar amount per month toward the insurance premium for each employee. This idea allows the employer to budget insurance expenses and pass future increases directly to the employee.

The problem that most employers have with this form of defined contribution is that most California insurance carriers and health plans offer only age banded rates for groups with 2-50 employees. The set amount of premium has to be the same within each class of employee, and the additional cost between age groups varies greatly. The older age groups end up paying a greater portion of the premium or choosing a lesser benefit plan that is more affordable.

The most commonly used defined contribution plans are **health reimbursement arrangements (HRAs)**. In June 2002, the Internal Revenue Service issued Ruling 2002-41 and Notice 2002-45 addressing employer paid health reimbursement arrangements. These communications enable employers to establish tax-deductible and tax-free HRAs,

pursuant to Section 105 of the Internal Revenue Code. In existence since the 1950s, these benefit options have garnered significant interest as of late due to their ability to make employees more cognizant of health care spending while providing sufficient medical coverage.

The increased interest in HRAs is a direct result of the need for employers to combat the rising costs of medical care without upsetting the financial balance of operations. As health insurance premiums continue to grow at an alarm-



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ing rate, employers are presented with two options to deal with this cost increase.

First, they can shift a percentage of the premium to their employees. Many employers are reluctant to do this as health care benefits are an attractive tool for employee recruitment and retention. Second, employers can revert to a high deductible insurance policy. While a high deductible insurance plan will control the cost of the premium, it will increase the employees' exposure to uninsured medical expenses.

HRAs help employees deal with the increased exposure generated by higher-deductible health insurance plans by allowing employers to set aside a specific amount annually for employees to use for payments of health care expenses not covered by insurance, such as deductibles.

While HRAs provide an effective way for employees to manage health care costs, employers often bear the burden of hidden administrative fees, in addition to the responsibility for benefit compensation. Therefore, it is essential that employers examine additional tax-advantaged employee benefit strategies when determining the appropriate benefits option. One such plan is the **Section 125 cafeteria plan**.

Section 125 plans, or **flexible spending accounts (FSAs)**, allow employees to use a predetermined amount of pre-tax dollars towards medical expenses, including insurance premiums and uncovered medical expenditures such as vision, dental and dependent care. When an employee takes advantage of a section 125 plan, pre-tax dollars are used to fund the plan, reducing personal tax liability for the employee and Social Security and Medicare responsibilities for the employer.

In many cases, Section 125 represents the best investment for both large and small businesses. Organizations pay small administrative fees to enhance employee loyalty and productivity and gain significant tax savings.

As mentioned, a key detriment to HRAs can be employer cost. Unlike HRAs, Section 125 plans are employee-funded, with the employer only paying for the cost of the administrative services. Often, the cost of administration is more than offset by the savings incurred by lowering the employer's FICA tax payments. This key difference provides both an attractive benefit for employees and low risk for employers.

Section 125 FSA plans are not without their drawbacks. Unlike HRAs, which afford employees a carryover of funds into subsequent plan years, the 'use-it-or-lose-it' rule of FSA plans dictates that unused funds are forfeited at the end of a plan year. A bill to amend Section 125 to allow for up to \$2,000 per plan year to be carried over into subsequent plan years is currently being considered by the U.S. House Committee on Ways and Means.

It is possible for an HRA and a Section 125 plan to co-exist. However employers should be careful when combining the two. The HRA is an employer-funded medical reimbursement plan. An employee cannot fund this benefit through salary reduction, nor can an HRA offer cash in lieu of an employer contribution. These restrictions must be clearly understood before acceptance of plan term in order to achieve maximum effectiveness.

The development of HRAs, along with the continued availability of Section 125 plans, gives employers many options from which to choose. Business owners must carefully consider the rules and features of all the different plans before choosing the plan that best suits each individual business.

Employers must examine the goals unique to their enterprise, as well as their employees, and ultimately choose the plan that will best help achieve those goals.

The goal of Cavnac & Associates' Employee Benefit Department is to introduce methods of enhancing employee retention, managing health care expense budgets, and promoting fiscal responsibility in order to help business owners grow and prosper. ✨

Property/Casualty Insurance Industry Earned 1% in 2002

New York – The property/casualty insurance industry reported a statutory rate of return of 1% in 2002, an improvement over the worst-ever negative 2.4% recorded in 2001. The results were released by the Insurance Services Office, Inc. (ISO) and the National Association of Independent Insurers (NAII).

Robert Hartwig, senior vice president and chief economist for the Insurance Information Institute, prepared a six page commentary saying that although the property/casualty insurance industry's swing to profitability was welcome, massive charges taken during the fourth quarter to strengthen reserves and the continued weak investment environment took their toll, rendering 2002 a significant disappointment from a financial perspective.

While some insurers hit profit targets in 2002, **last year's combined ratio of 107.2 was at least 15 points above where the industry needs to be**, given the current dreary investment climate, in order to generate rates of return similar to that of the Fortune 500.

On a more positive note, rate increases appear to be leveling off for some lines of coverage (property in particular), although rate increases on average nationwide edged up from 25% to 28%.

Bottom line: the insurance industry will only return to health when rates are high enough to generate an adequate rate of return to attract investors.



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