Research Advisory

Canadian Research Group

Hewitt

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Highlights

The 2008 Federal Budget proposes to exclude prescribed over-the-counter drugs (OTCs) as an expense eligible for the Medical Expense Tax Credit (METC). This has created some confusion in the insurance industry as to whether prescribed OTCs are, therefore, excluded from group benefit plans.

The Hewitt Research Advisory is a regular Hewitt newsletter designed to provide a detailed overview of specific legislative and regulatory developments in Canada relating to human resources.

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Federal Budget 2008 Update – OTC Drugs and Group Benefit Plans

The 2008 Federal Budget proposes to exclude prescribed over-the-counter drugs (OTCs) as an expense eligible for the Medical Expense Tax Credit (METC). This has created some confusion in the insurance industry as to whether prescribed OTCs are, therefore, excluded from group benefit plans.

What Are OTC Drugs?

"Over-the-counter" drugs, are pharmaceutical products which can be purchased without a prescription (the drugs can be prescribed but this is not a necessity). OTC products are used for the treatment of conditions that individuals can recognize and manage by themselves.

The Medical Expense Tax Credit – Definition and Purpose

The METC provides income tax relief equal to 15 per cent of eligible medical and disability-related expenses in excess of the lesser of 3 per cent of the individual's net income and $1,962.

Section 118.2 (2) of The *Income Tax Act (ITA)* defines "eligible medical expense" for the purposes of the METC. The Budget proposes to change the wording of this section to clarify that prescribed OTCs are ineligible for the METC.

The Issue

The issue for sponsors of group benefit plans is whether or not the Budget provision directed at the METC also means that prescribed OTCs are ineligible for payment from a Private Health Services Plan (PHSP).

Impact on PHSPs -- Two viewpoints

CLHIA Interpretation
The position of the Canadian Life and Health Insurance Association (CLHIA) is that the proposed change does not apply to group health plans. Specifically, CLHIA believes that PHSPs are not required to limit their coverage to those expenses eligible for a METC and requested clarification from Finance Canada.

We understand that the initial response from Finance supports CLHIA's interpretation, and indicates that it was not the intent of the government to change the tax rules surrounding PHSPs through the Budget.

Hewitt Commentary: *We expect that there will be additional reviews of this position, by either Finance Canada or the Canada Revenue Agency. Until both are in agreement on the application of the new s. 118.2(2) (n), there will continue to be uncertainty regarding the Budget's impact.*

If the CLHIA position prevails, it raises the question whether s. 118.2(2) is the definitive list of what is eligible for reimbursement under a PHSP.

If PHSP's are not constrained by s. 118.2(2), the question becomes whether additional services or products could become eligible under PHSPs. Without a definitive list, it is unclear what services might be eligible, but examples might include:

- herbal medicines
- naturopathic remedies (without a Drug Identification Number)
- vitamins or nutritional supplements (with or without a DIN)
- health promotion activities or services, such as fitness memberships, weight loss programs

Plan sponsors should see this lack of clarity as both a potential risk and a potential opportunity.

If a change of this nature broadens the range of services eligible as medical expenses, there would be new interest from employees and union groups to add these additional services to medical plans. Adding new services could potentially increase cost for plan sponsors.

However, for employers who either currently support, or who are looking to expand support for employee health and wellness activities, an expansion of what is eligible under a PHSP could provide a tax incentive for these initiatives. Either through direct employer funding of these programs, or by allowing employees to purchase such programs tax-effectively through a Health Spending Account (HSA), broader support for health and wellness could reduce employer costs in the long term by keeping employees healthier and more engaged in the workplace.

Alternative Interpretation
Another view expressed by some practitioners is that prescribed OTC drugs will no longer be eligible medical expenses under PHSPs. The reasoning is that, regardless of the intent of the Budget, the

Income Tax Act and income tax interpretation bulletin *IT339- R2* state that to qualify as a PHSP eligible expense, the expense must also be eligible for the METC.

If this viewpoint were to be confirmed, individuals would not be able to claim prescribed OTC drugs, such as smoking cessation products, vaccines and OTC blood thinning products, under a PHSP.

Hewitt Commentary: *Prior to the Budget announcement, the common understanding was that s. 118.2(2) was the definitive list of eligible expenses under PHSP's, and is in fact directly referred to in some insurance contracts.*

If this link to s. 118.2(2) were confirmed, most employers would be affected by this change to some degree. Since most plans do cover some life-sustaining OTC products, and employers with HSA's generally cover all OTC drugs with a prescription, changes will be required by most plan sponsors.

If this view prevails, plan sponsors will need to:

- *understand the impact on their health care plans;*
- *ensure their claims adjudicators no longer reimburse plan members for these expenses from the PHSP, retroactive to February 26;*
- *modify their insurance contracts to reflect this change;*
- *review employee communications to clarify these new provisions;*
- *review collective bargaining agreements for potential conflicts with the Budget (depending on the wording of the agreement, the employer may still be required to reimburse prescribed OTCs outside of the PSHP which would generate a taxable benefit to the plan member)*

In light of the initial response from the government, the insurance industry has not implemented any administrative changes at this time. However, given the historical view of connecting PHSP's directly to s. 118.2(2), there remains some question as to which interpretation will eventually prevail.

Once the issue is clarified, and if changes are required, they will need to be made retroactively to February 26, 2008. This could create a challenge for plan sponsors, as their plan adjudication, administration of taxable benefits, contracts and employee communications would also need to be changed to reflect that retroactivity.

For this reason, employers should continue to monitor this issue. Ideally, additional clarification will be available as soon as possible to minimize the impact of having to make changes retroactively.

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