Implications and Planning for the Affordable Care Act and the Service Contract Act

A brief overview for government contractors.

The Boon Group, Inc.
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Introduction
The McNamara-O’Hara Service Contract Act of 1965 (SCA or Service Contract Act), as amended, and including associated regulations found at 29 CFR §4.1 et seq. requires private contractors on federal service contracts exceeding $2,500 in value to provide certain labor categories with hourly health and welfare benefits. Labor categories with health and welfare requirements under the Service Contract Act are determined by the Fair Labor Standards Act (FLSA), and include all non-exempt employee positions. Examples of non-exempt employees under federal government contract are custodians, security guards, clerks, etc.

The pay rates and health benefits required under SCA contracts are spelled out in the wage determination attached to the specific service contract. The general rule is that “bona fide” health and welfare fringe benefits are typically owed on hours worked by the employee, up to 40 hours per week. The current health and welfare fringe rate is $3.81 per hour, or $152.40 per week, or $660.40 per month. Although the law requires the government contractor to provide benefits in a specified hourly amount, contractors can decide to pay cash in lieu of “bona fide” benefits, provided that the combination of benefits and cash equal the amount required under the contract.

It is important to note there are some legacy contracts still in existence called “average cost” contracts which require benefits to be paid on all hours worked, and are not capped at 40 hours per week. Unlike the standard protocol which requires benefits to be tracked on an individual basis, under an average cost contract benefits can be averaged across all employees to determine compliance. Although average cost contracts are rare, determining the type of contract will ensure that the fringe dollars are being allocated appropriately. To identify the type of contract, “average cost” contracts have even numbered wage determinations, whereas the standard or “individual cost” contract has an odd numbered wage determination.

The Service Contract Act requires that benefits be tracked on an hourly basis. In order to satisfy the fringe benefit obligation, a contractor must:

- Provide fringe benefits separate from, and in addition to, specified wages
- Discharge the fringe obligation either in “bona fide” benefits or cash in lieu of benefits
- Note that wages paid in excess of the wage determination minimum wage requirement cannot offset fringe requirement
- Track the expenditure of the fringe allocation to account to demonstrate compliance with the SCA
- Know that the employer, not the employee, has the right to choose how fringe dollars are allocated

In addition to the Service Contract Act regulations, The Patient Protection and Affordable Care Act (ACA or Affordable Care Act) will require most contractors with more than 50 full-time employees to offer minimum essential coverage to employees and their eligible dependents. If the employer fails to offer minimum essential coverage, the employer will pay a penalty (in the form of an excise tax) if even one full-time employee receives federal assistance (in the form of a subsidy) to purchase health coverage on a federal or state based exchange. Failure to offer a plan which meets minimum essential coverage guidelines will result in penalties of $2,000 per full-time employee per year (not including the first 30 employees) if any full-time employee receives subsidized coverage on the exchange.

In addition to offering minimum essential coverage, each employer/contractor looking to avoid penalties under the ACA must also provide their employees an affordable health care plan that provides minimum value. An affordable plan is one in which the required contribution for self-only coverage does not exceed 9.5 percent of the taxpayer’s household income. Thus, employers who choose to pay less than 100 percent of the cost of an employee’s insurance will be required to prove that the employee’s share...
of the health insurance premium meets these government guidelines. In order to provide minimum value, the plan is required to cover 60 percent of total plan costs\(^{12}\). Failure to meet the requirement to offer affordable care that meets the minimum value test will result in penalties of up to $3,000 per each employee that receives subsidized coverage on an exchange\(^{13}\). Note, however that this penalty cannot be larger than the penalty the employer would have paid if the employer failed to offer a plan that provides minimum essential coverage\(^{14}\).

**Do all contractors need to comply with the Affordable Care Act?**

The answer is “yes” and “no.” The Affordable Care Act itself applies to contractors just as it would a traditional employer. However, the ACA imposes a penalty on “large employers” (i.e., most employers with at least 50 full-time equivalent employees) that fail to offer minimum essential health coverage that is affordable to those employees. Recently, the IRS issued long-awaited final regulations regarding the shared responsibility provisions that state employers with less than 100 full-time employees throughout the year in 2015, may not be subject to the law. If a contractor has less than 50 full-time employees throughout the year starting in 2016, the contractor may not be subject to the law. There are additional exceptions, however, and contractors with varying workforces should take note. If an employer has part-time or seasonal employees there are procedures to calculate when these employees count toward the 50 full-time equivalents. Additionally, there are special rules that apply to employers that are part of a “controlled group.” A grey area does exist around ACA topics relevant to contractors. Until guidance is provided, contractors should take careful consideration if there is even a question as to whether the ACA requirements apply.

**Complications for Contractors**

Compliance under ACA can be complicated because, unlike the traditional employment landscape, contractors working under the Service Contract Act have fringe dollars available with which to provide coverage. How the fringe dollars are allocated will determine whether or not the contractor will be subject to penalties under the Affordable Care Act. For example, contractors could incur penalties under the Affordable Care Act employer mandate to offer affordable coverage if fringe dollars are not properly allocated. This is because fringe dollars can be viewed as employer or employee contributions based on how the employer offers the coverage. Contractors who structure their plans as 100 percent contributory will find that their fringe dollars will be viewed as employee contributions. Contractors who utilize the fringe to pay their employer share of health premiums will have an advantage, because the premiums are then considered employer contributions. So how do government service contractors best position themselves?

**Satisfying ACA Requirements**

To align themselves with the Affordable Care Act’s employer shared responsibility provisions, and to use fringe benefit dollars to satisfy the employer mandate to provide affordable coverage to its full-time population, a contractor should remove “cash as an option.” By providing an employee with the choice of cash in lieu of health benefits the employee has “constructive receipt” of the fringe dollars which makes those dollars taxable\(^{15}\). In other words, the funds are considered to be employee money rather than employer money.

Section 125 cafeteria plans were developed to allow employees to pay for their cost of health and welfare benefits with pre-tax dollars. Under a Section 125 Plan an employee elects to receive cash or benefits. If the employee elects the cash, the employer is paying the employee wages. If the employee elects benefits, the wages the employer has paid are then used on a pre-tax basis to fund the employee’s share of any health care costs. Under the ACA employer mandate, the employer is responsible for offering and paying for part of the cost of certain health benefits. Paying the fringe in cash, which in turn the employee elects to use under a 125 Plan to pay for benefits, does not satisfy this requirement. This is because the payment through the Section 125 Plan is coming from employee funds, not employer funds. It is this personal election by the employees to use their wages and have those withheld pre-tax to pay for certain benefits which disallows fringe dollars to satisfy the employer mandate.

Fringe dollars are only considered employer dollars when the employer pays for the plan benefits through premiums to an insurance carrier, or contributions to a self-funded plan. For a contractor to structure a compliant plan using fringe dollars, contractors can use the following methods:
• Require employees to participate in the employer health plan.
• Require employees to participate in the employer health plan unless they have a valid waiver, in which case the fringe dollars can then be used to provide a different form of “bona fide” benefit, such as a retirement plan.
• Offer a defined contribution style plan, where an employee can choose between a selection of benefits. The plan, however, would need to be structured in a way that it is outside the scope of a cafeteria plan (Section 125) and funded with only employer fringe dollars. Cash could not be an option.
• Provide cash in lieu of benefits under limited circumstances. The contractor can pay the underspent fringe (i.e. the remainder of the fringe dollars not used as premiums) as cash wages provided that the employee is required to participate in the health and welfare benefit plan, or provide proof of other coverage in order to waive coverage under the contractor’s health plan. This process, however, is not recommended as the employer will pay the payroll tax burden on any cash payments, and also leaves fewer dollars with which to provide a plan that is affordable and provides minimum value.

Minimizing Exposure to Costs
Fringe increases have averaged 3.43 percent over the last seven years\textsuperscript{16}. Increases for health insurance for single coverage have averaged 5.11 percent\textsuperscript{17}. As a result, government contractors will have tough decisions to make in order to try to control escalating health costs which exceed fringe increases year over year. Contractors looking to be competitive and successful will need to develop programs that limit their financial liability to the fringe dollars available. Contractors concerned about minimizing exposure can take measures to reduce their risk of incurring rising insurance costs. The best way to minimize risk under a government services contract is to reduce or eliminate adverse selection. Adverse selection occurs when employees with existing health conditions or accelerated age choose coverage to address those factors, but the healthier and younger employees do not choose to participate in the plan, resulting in high claims costs without adequate premiums or contributions to offset those costs.

Adverse selection can be the most devastating aspect to a government contractor’s plan. Contrary to the private sector, where employees choose payroll deductions as a means to purchase benefits, contractors must pay the health and welfare fringe amounts in addition to base cash wages. Paying the fringe in cash to an employee who can voluntarily choose to participate in the health coverage can cause a spiral of adverse selection, which leads to escalating costs. This is because in this scenario a contractor is essentially paying an employee to waive their health plan.

Best Practices
Government contractors are squarely in the cross hairs of regulations borne from the Affordable Care Act. Regardless of the type of contract for which contractors are bidding or fulfilling, they will need to select their benefit offerings with careful consideration moving into 2014. The ACA adds another level of bureaucracy to contracting within an industry already burdened by regulation and oversight. In the very near future many contractors working under the Service Contract Act will need to make some tough choices when it comes to benefit decisions. Whether or not the requirement to offer affordable care will be the determining factor in bid costs will be dependent on those choices. Developing a predictable and compliant model in which to offer benefits is important to contractors.

In the end, a contractor can minimize exposure to benefit costs that exceed the health and welfare fringe available by trying to cover 100 percent of the premium cost of employee level health coverage using fringe dollars, as well as considering offering ancillary benefits (dental, life, disability, vision) on a voluntary employee-paid basis. To become more competitive, contractors should consider eliminating contributions toward dependent coverage and structure a benefit plan that can accommodate premium increases year over year. Contractors looking to build a predictable cost model also should move towards reducing or eliminating any sick leave or excess vacation provided above what is required by the contract, to make room for increasing healthcare premiums. In a low bid situation, contractors also should consider contributions to retirement secondary to health benefits and back down or eliminate employer matches altogether. Most importantly, the contractor should stop any remaining cash payments in lieu of providing benefits with the fringe dollars. In making payments as cash wages to the employees, in lieu of providing benefits, contractors take on additional payroll tax burden in a competitive environment.
We invite you to contact us at 866-831-0847 if you have questions.

SOURCE

1 Wage Determination information is found at www.wdol.gov
2 29 C.F.R. § 4.170
3 29 C.F.R. § 4.171(a)
4 29 C.F.R. § 4.177
5 29 C.F.R. § 4.170
6 29 C.F.R. § 4.170
7 29 C.F.R. § 4.177
8 26 U.S. Code § 4980H(c)(2)(A)
9 26 U.S. Code § 4980H(c)(2)(D)(i)
10 45 CFR 156.145
11 Notice 2012-58, 26 CFR Parts 1, 54 and 301
12 45 CFR 156.145
13 26 U.S. Code § 4980H(b)(1)
14 45 CFR 156.145
16 26 CFR 1.451-2
17 www.wdol.gov/aam.aspx; AAM 214, 211, 210, 209, 206, 204, 203,202

About the Author

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