



THE PSC ANNUAL CONFERENCE

THOUGHT LEADERSHIP ARTICLE

# SERVICE CONTRACT ACT

HEALTH & WELFARE BENEFITS UNDER  
THE AFFORDABLE CARE ACT

# CONTRACTOR OBLIGATIONS, OPTIONS AND BEST PRACTICES

by BICKNELL C. ROBBINS, ESQ.

President, Government Contracting Practice  
CBIZ Benefits and Insurance Services, Inc.

Employers who have contracts with the federal government that are subject to the Service Contract Act (SCA) must meet the wage and benefit provisions of the contract's Wage Determination (WD). The WD specifies the labor classifications, associated minimum hourly wage rate, the minimum hourly Health & Welfare (H&W) fringe rate, and the vacation and holiday benefits covered service employees are entitled to.

### **How to Spend SCA Fringe Dollars is the Employer's Decision**

It is important to understand that the hourly H&W fringe benefit rate listed in each "fixed cost" wage determination is an employer obligation separate from the hourly cash wage the employee receives. The SCA employee is not entitled to receive any portion of this fringe rate in cash, although the employer may choose to discharge its obligation by simply paying the fringe rate to the employee in cash. Nor is the employee entitled to select which benefits the employer will provide. The DOL Field Operations Handbook states that "The types of benefits or cash equivalents to be provided [to employees] is strictly a matter to be decided by the employer."

Some SCA employees misunderstand the law and feel they should be able to direct how the hourly fringe is spent. They view the hourly fringe as "their" money and feel the employer should not be able to force them to take benefits they don't want. This is simply not the case.

As long as the benefit premium is being paid directly out of the hourly fringe rate, the employer can require the employee to participate in that benefit plan. The hourly fringe is considered to be an employer cost. When an employer pays for a benefit out of the hourly fringe, it is considered to be at no cost to the employee, as the employee is not entitled to that fringe in cash or entitled to direct how that fringe should be spent. It is the same as when an employer pays for a benefit for a non-SCA employee without requiring the employee to pay anything through payroll deduction.

### **Benefits or Cash-in-lieu?: Easier isn't Better**

SCA regulations provide that the employer can meet the hourly H&W requirements by:

- providing benefits to each employee costing the employer a minimum of the hourly H&W fringe;
- providing the employee with a cash payment in lieu of benefits; or
- a combination of the two.

Most employers pay health and welfare premiums in monthly amounts. This presents the challenge of then accounting for those monthly payments for each individual SCA employee to determine if they were sufficient to meet the hourly H&W minimum based on the employee's hours for that month. This often results

in the employer looking for a way of meeting the fringe that eliminates the need for this seemingly complicated accounting.

Providing the H&W hours to the employee in cash seems like a simple solution. The employer simply provides the employee the hourly fringe as cash in lieu of benefits each pay period. The employer could still offer employees the option of purchasing benefits through pre-tax payroll deductions, effectively allowing the employee the choice of taking the fringe in cash or spending some or all of it on benefits. However, if the H&W fringe is managed in this manner, experience tells us most employees will opt to take the cash. This has two negative impacts to the company.

- First, it creates the likelihood of adverse selection in the company's medical plan, resulting in higher claims experience. If employees are offered cash as an alternative to health benefits, they will generally take the cash unless there is an expected or immediate need for the health coverage. This means that those electing to take medical benefits will be those most needing the coverage, which in turn drives up medical claims and ultimately drives up insurance rates.
- Second, if the H&W is taken in cash, it constitutes a taxable wage and actually increases the employer's costs. At a minimum the employer experiences the 7.65% FICA tax on H&W dollars paid in cash. But it also likely incurs additional costs in the form of premiums that are cash wage driven, such as workers' comp and general liability premiums. This additional cost could be as high as 25%.

### **Providing Cash with Benefits as an Employee Option – Not a Good Solution**

In some cases the contractor may provide a benefit package, but permit the employee to waive benefits in certain cases. Employee's waiving benefits are then provided some or all of the hourly fringe in cash. In addition to the negative impacts listed above, this increases the administrative burden of meeting the hourly H&W requirements. Any cash payments to employees that are intended to meet the hourly H&W requirement must meet the following requirements:

- They must be stated separately from the hourly cash wage the employee is paid.
- More importantly, they must be paid on the same schedule as the cash wage that is being paid for those hours.

In other words, unlike payments to "bona fide" fringe benefit plans which can be made quarterly, payments to employees of any cash intended to satisfy the fringe have to be made on the regular pay date for those hours. This is typically bi-weekly. Making the necessary calculation as to what additional cash in lieu of fringe the employee is due by the required payroll date is often logistically

impossible. Employer's may find themselves requiring additional time to make the calculation, which then results in non-compliance with the regulations.

Beginning in 2015 employers who opt to pay cash-in-lieu of benefits may experience the additional negative impact of the "shared responsibility" excise tax. This tax could be as much as \$2,000 times the number of full time employees over 30. This would be applied to the employer's total employee population, not just the SCA employees receiving cash-in-lieu of benefits. For those SCA employers who will be subject to this potential excise tax, the additional cost it imposes on the "cash-in-lieu" method of compliance is prohibitive.

To illustrate the dramatic impact the shared responsibility provision will have on SCA employers providing cash-in-lieu of benefits, let's look at the following example:<sup>1</sup>

Acme Service Contractors, Inc. has 200 full time employees. 50 of these employees work in the corporate office or on non-government contracting projects. These 50 employees are offered medical insurance that meets the "adequate coverage at an affordable rate" requirements of the Affordable Care Act. The remaining 150 employees are employed on a government contract subject to the SCA. The Wage Determination for this contract specifies an hourly H&W requirement of \$3.71 per hour for all hours paid, up to 40 hours per week.

To meet its hourly H&W obligation under the contract, Acme provides each SCA employee working on the contract a payment of \$3.71 for each hour paid in addition to the employee's regular hourly wage. This satisfies the employer's H&W obligation under the Service Contract Act as set forth in the Wage Determination.

Employee A is a SCA employee working for Acme and has a household income that is less than 400% of the federal poverty level. Employee A purchases health insurance through a public exchange and receives federal assistance towards the payment of the premium.

Because Acme has more than 50 full-time employees but does not offer adequate coverage to at least 95% of these employees, it is subject to the adequate coverage excise tax. Due to the fact that at least one of its full time employees purchased through an exchange and received federal assistance, that tax will be assessed. The tax due will be calculated as 170 employees (200 minus 30) times \$2,000 or \$340,000.

Let's now assume that Acme provides its SCA employees with cash-in-lieu of benefits equal to the required \$3.71 per hour but allows the SCA employees to

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<sup>1</sup> A detailed discussion on who is subject to the excise tax and under what circumstances is beyond the scope of this article.

then elect health coverage under the company's medical plan. SCA employees who elect coverage agree to pay the full cost of the coverage through payroll deduction on a pre-tax basis under the company's Section 125 Premium Conversion Plan. Under this example, Acme is providing adequate coverage to all employees. The question is whether it is "affordable coverage".

Coverage under an employer-sponsored plan is deemed affordable to a particular employee if the employee's required contribution for single coverage does not exceed 9.5% of the employee's household income for the taxable year. For this purpose, household income means the modified adjusted gross income of the employee and any members of the employee's family (which would include any spouse and dependents) who are required to file a federal income tax return.

If the offered coverage is deemed unaffordable and at least one employee purchases health insurance through an exchange and received federal assistance, the employer will be subject to an excise tax equal to the lesser of:

- Number of credit employees<sup>2</sup> multiplied by \$3,000 per year, or
- Number of full-time employees minus the first 30 multiplied by \$2,000 per year.

If Acme is paying cash-in-lieu of benefits, that makes those payments a taxable wage to the employee. In our opinion, if a SCA employee then elects employer provided coverage and pays for that coverage through a payroll deduction of his or her cash wage, including the cash wage representing the hourly H&W payment under the Wage Determination, 100% of the cost of that coverage is being paid for by the employee and that cost should be used to determine whether the coverage is affordable.<sup>3</sup> With single coverage exceeding \$400 per month being a common occurrence, it's almost a certainty that an employer paying cash-in-lieu of benefits while still offering health coverage to employees under this scenario will be found to not offer "affordable care" and therefore be potentially liable for the excise tax.

Many employers have asked if the DOL is contemplating doing away with the cash-in-lieu option once the individual mandate and shared responsibility rules go into effect. In our conversations with the DOL they have indicated that there are currently no ongoing discussions to do away with cash-in-lieu as a method of

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<sup>2</sup> A credit employee is one who works at least 30 hours per week and who is eligible for a premium tax credit or cost sharing assistance for buying insurance through an exchange

<sup>3</sup> Recently the ERISA Industry Committee submitted comments to the Department of Treasury/IRS recommending that cash in lieu payments to Service Contract Act employees who are otherwise offered medical coverage be treated as an employer contribution to the cost of that benefit. If this position is adopted, then paying cash in lieu of benefits and offering employees minimal essential coverage that can be elected and paid for out of the cash in lieu payment should avoid the excise tax.

compliance. Our sense is that the Wage and Hour division responsible for enforcing SCA compliance is focused strictly on those issues. If an allowable method of compliance then results in an excise tax, that's an enforcement issue of the Treasury Department and doesn't impact Wage and Hour's enforcement initiatives.

### **Best Practices**

Because of these negative impacts, most government contractors are moving away from cash in lieu of benefits as a means of compliance. The following is what many consider to be a "best practices" approach:

- Provide full time SCA employees with a base Health and Welfare plan consisting of Employee Only Medical, Basic Life and Disability, and some other ancillary benefits such as Dental or Vision. This base plan is paid for entirely out of the employer's required hourly contribution per the wage determination.
- Allow employees to buy up to additional coverage with a combination of employer H&W dollars and employee pre-tax dollars.
- Allow employees who have proof of other group medical coverage (including Tricare) to waive the Medical coverage. Requiring proof of other coverage mitigates against the likelihood of adverse selection.
- If an employee waives coverage or otherwise doesn't utilize the entire fringe on health and welfare benefits, the remaining SCA fringe dollars are contributed on a periodic basis to the employer's qualified retirement plan, usually a 401(k) plan. This is an employer contribution and accounted for separately by the record keeper from employee deferral contributions. This contribution does not need to be made each pay period but rather can be made on a quarterly basis. The employer or benefit administrator thus has time to make the necessary calculations and make sure they are neither over nor under paying the fringe for each employee.

This approach gives some flexibility to the employee in his or her choice of benefits (which improves employee morale), allows employees having coverage elsewhere to waive so they don't have to have double coverage (also improving morale), and eliminates the cash in lieu option and its attendant negative impact (improving the contractor's bottom line).

The approach does carry with it the need to account for the benefits provided to make sure they meet the hourly minimum for each covered employee. However, there are benefit plans available that have been specifically designed to manage this accounting. In addition, the contractor can outsource the hourly H&W accounting to a Third Party Administrator that specializes in managing SCA fringe benefit compliance.