Service Contract Act Health & Welfare Benefits

Contractor Obligations, Options and Best Practices

by

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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.

It is important to understand that the hourly H&W fringe benefit rate listed in each "fixed cost" wage determination is an <u>employer</u> 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.

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%.

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 additional 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.

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 we 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.