EMPLOYEE BENEFITS CONSIDERATIONS UNDER THE SERVICE CONTRACT ACT

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This FAQ document summarizes the employee benefits considerations under the McNamara-O’Hara Service Contract Act (“SCA”) and provides examples of how to comply with the SCA. As discussed below, this has become increasingly complicated for employers subject to the Employer Pay or Play mandate under the Patient Protection and Affordable care Act (ACA). For additional information regarding the employee benefits considerations under these acts, see the Department of Labor (“DOL”) compliance guidance.

OVERVIEW

What is the SCA?

The SCA generally applies to those entities performing work under federal contracts (“contractors”). The SCA requires contractors to pay prevailing wage rates and fringe benefits to service employees working under those federal contracts. The required fringe benefits and wage rates will be specified in the federal contract. The fringe benefit obligation may be met by paying cash in lieu of providing benefits.

What dollar amount of fringe benefits must be provided?

For many service employees, the dollar amount of fringe benefits that must be provided under the SCA currently is $3.81 per hour, not to exceed 40 hours a week. Therefore, in addition to the required hourly wage, these employees must receive an additional $3.81 per hour in fringe benefits. Some contracts may differ based on the effective date of the contract and other factors.

Assuming a $3.81 fringe rate, an employee working 40 hours a week is entitled to an additional $152.40 a week, which is over $600 per month. This amount will often exceed the entire monthly premium cost for employee-only coverage.

Can an employer/contractor pay employees their fringe benefits in cash instead of furnishing the required “fringe benefits”?

Generally, yes. Paying employees their fringe benefits in cash does not have the same tax advantages as providing employees with fringe benefits because cash payments are subject to payroll taxes and income tax withholding. Many contractors choose to pay in cash to avoid the burden of maintaining benefit plan coverage for these employees, but in addition to the tax implications, this approach has potential Pay or Play implications for those employers subject to the mandate, discussed below.

An employer can meet their fringe obligation by paying part toward health plan coverage and providing the rest in cash.

HOW TO MEET FRINGE OBLIGATIONS
Under the SCA, if an employer/contractor chooses to provide employees with fringe benefits, how must the contractor provide the fringe benefits?

An employer/contractor can meet its obligation to provide fringe benefits by making a contribution to a trustee or third person pursuant to a “bona fide” fringe benefit fund, plan, or trust on behalf of the covered employees.

To be considered a “bona fide” fringe benefit, the plan, fund, or program must constitute a legally enforceable obligation which meets the following criteria:

- The fringe benefit plan must be communicated in writing.
- The primary purpose of the plan must be to pay for benefits to employees on account of death, disability, advanced age, retirement, illness, medical expenses, hospitalization, and the like. Examples include:
  - Medical plan
  - Dental plan
  - Vision plan
  - Life and ADD Insurance
  - Long term disability
  - Contributions to a retirement plan that is 100% vested (no vesting schedule is permissible because of the requirement that contributions be irrevocable)
  - Vacation and holiday benefits
- The plan must contain a definite formula for determining the amount to be contributed by the contractor and a definite formula for determining the benefits for each of the employees participating in the plan.
- Any contributions made by employees must be voluntary (employee contributions cannot be used to satisfy SCA fringe benefit obligations).
- The contractor’s contributions must
  - be paid irrevocably to a trustee or third person
  - at least quarterly
  - pursuant to an insurance agreement, trust or other funded arrangement

The key concept here is that the contribution be irrevocably paid to a third party. In other words, the employer/contractor no longer has control over or access to that contribution.

The following are not considered “bona-fide” fringe benefits:

- Any benefit required by any other federal law or by any state or local law, such as unemployment compensation, workers’ compensation, or social security.
- Contributions to a health FSA are likely not a bona fide fringe benefit because they would not be irrevocable as a result of the use it or lose it rule.

Can a contractor satisfy its obligation to provide fringe benefits if it covers the employees under a self-insured health benefit plan?
Self-funded plans seeking to meet their fringe obligations through the medical plan must be funded by a trust or, in the alternative, seek approval from the Department of Labor-Wage and Hour Division to meet fringe requirements. A DOL-produced checklist for this process is included at the end of this FAQ.

Unfunded or self-funded plans submitted to the Department of Labor for review should include documentation that:

1. Explains the funding/contribution formula
2. Explains the financial analysis methodology used to estimate the costs of plan benefits and contributions to it
3. Specifies the frequency of employer contributions to the plan
4. Identifies the administrator of the plan and the source of the funds the administrator uses to pay the benefits provided by the plan
5. Advises of the ERISA status of the plan
6. Identifies how the plan is communicated to employees.

Plans should be submitted to: Branch of Government Contracts Enforcement, Room S-3006, Wage and Hour Division, U.S. Department of Labor, 200 Constitution Avenue, NW, Washington, DC 20210.

INTERACTION WITH ACA EMPLOYER PAY OR PLAY MANDATE

The DOL provides that SCA-required fringe benefits that are legally required to be provided under other federal, state or local laws do not “count” towards the fringe benefit requirements. For example, benefits required under Hawaii-mandated pre-paid Health Care Act are not credited toward the contractor’s SCA obligations.

Does this mean that group health plan coverage provided pursuant to Pay or Play will not “count” as fringe benefits under the SCA?

Although the DOL has not addressed this issue, most agree that the Pay or Play mandate does not technically “require” employers to provide group health plan coverage. Rather, it imposes a tax on those employers that do not provide group health plan coverage to a sufficient number of full-time employees or that offer group health plan coverage that is unaffordable or not minimum value. Thus, benefits provided to avoid potential Pay or Play Penalties should count towards SCA fringe benefit requirements. Additional guidance on this issue would be helpful.

If an employer/contractor pays covered employees their fringe benefits in cash, will the employer/contractor that is a large employer under the ACA be compliant with Pay or Play?

Where the employer allows SCA employees a choice between fringe benefits (medical coverage) or cash, it is possible the employer will receive no credit for a contribution to the plan, but would still have the obligation to provide affordable coverage for full-time employees. Accordingly, employers subject to Pay or Play who have a cash-in-lieu provision could run into problems with the affordability of their plan and potentially be subject to penalties.

Many employers have historically allowed employees to take cash instead of fringe benefits to meet SCA obligations. Industry experts have written the IRS recommending employer/contractors who are in compliance with their fringe obligations (including the cash out) not be liable for Pay or Play penalties as long as the employer/contractor has made minimum essential coverage
available to these employees and the amount the employer/contractor pays *in cash or in benefits* would be considered “affordable” as an employer contribution (regardless of whether the SCA employee takes the coverage or the cash). The regulators have not responded to this recommendation. Unless and until such a response is issued, the conservative approach for an employer/contractor subject to Pay or Play is to meet fringe obligations by contributing to medical coverage and prohibit a cash-out option unless there is an excess fringe obligation after the employer makes an “affordable” contribution to the medical coverage.

**How does an employer make sure that the SCA fringe amount it is required to pay counts as an employer contribution to coverage for Pay or Play purposes?**

a. **Payment through a cafeteria plan**

Historically, employers have been able to use a flex credit design to satisfy their SCA fringe obligations. A flex credit allows employees to elect qualified benefits (e.g., medical, dental, vision, 401k etc.) or cash under a cafeteria plan. Employees who did not want medical coverage or who already had other coverage could simply elect the cash option. However, under ACA guidance, cashable flex credits will likely not count as an employer contribution to coverage.

While there is no direct regulatory guidance in the Pay or Play context, the IRS has said that for other ACA purposes (specifically the individual mandate affordability provisions), a flex credit counts as an employer contribution to medical coverage if:

1. There is no cash out option;
2. The credit can be used to pay for minimum essential coverage; and
3. The credit may only be used to pay for medical care within the meaning of Code § 213 (this means the flex credit cannot be used to purchase other qualified benefits not related to medical care, e.g., life insurance, 401k etc.)

Presumably the same interpretation will apply to Pay or Play affordability as well. This means that an employer could only count a flex credit toward affordability if the three conditions above are satisfied. Having a cash out option would result in the total amount of the flex credit being disregarded for affordability purposes, which means the employer-sponsored coverage would likely be considered unaffordable and potentially penalty-triggering. See below for an illustration.
To avoid this potential problem, employers administering the SCA fringe with a flex credit design through a cafeteria plan should require that a minimum portion of the flex credit be applied to the lowest cost employee-only medical coverage that provides minimum value (usually the employer’s base plan), and eliminate any cash out option of that amount. This makes that contribution a defined employer contribution that would be considered for ACA affordability purposes. Any remaining fringe payment could be applied to other qualified benefits available through the cafeteria plan, or cashed out.

Example: Employer offers a $600 flex credit, which will satisfy the amount of the fringe payment for its SCA employees. Employee-only coverage on the employer’s lowest cost plan that provides minimum value is $300. The employer requires that $300 of the $600 flex credit be applied to employee-only medical coverage, with no cash out option on this $300. The employee options would be as follows:

- Choose the $300 employee-only coverage, with the remaining $300 going to another qualified benefit under the cafeteria plan (e.g., 401k, etc.) or taken as cash (taxable income).
- Choose another level of coverage (e.g., a richer plan or a different tier of coverage to add spouse/dependents), with any remaining dollars going to other qualified benefits or being taken as cash.

1 Under the ACA, MEC and ALE reporting requirements, this amount generally must be reported on all full-time employees’ Form 1095-C.
b. Payment outside a cafeteria plan

Administering the SCA fringe payment outside a cafeteria plan also has potential risks. An employee who has an election between taxable and non-taxable benefits (e.g., cash versus health coverage) that is not offered through a cafeteria plan that satisfies Code §125 must include in gross income the value of the taxable benefit even if the employee elects to receive only the nontaxable benefits offered. This is known as the doctrine of constructive receipt. Here is an example of how that concept applies.

Example: Acme Company does not have a cafeteria plan. The company informally lets its employees choose in December of each year whether to receive health insurance coverage (a non-taxable benefit) for the following year. If they elect health insurance, they have to pay $50 per week for it. Acme tells employees that if they elect health insurance, they can pay for it on a pre-tax basis and that the company will pay them $50 less in wages per week (Acme will reduce their W-2 wages by $50 per week). According to the IRS, the employees who elect the health insurance have constructively received, and must include as taxable income, the $50 weekly cash compensation that they could have received instead of health insurance. Without a valid Code §125 cafeteria plan, the arrangement to reduce the employees’ W2 wages to pay for their health insurance does not work to avoid taxation.

In short, the Internal Revenue Service views this as an assignment of the employee’s wages to a third party (e.g., the insurance carrier providing the coverage). This means that the fringe payment would likely be treated as an employee contribution for purposes of the ACA affordability analysis, leaving the employer vulnerable to ACA penalties.

The safest approach is similar to the one set forth above in the cafeteria plan context. The employer should require that some portion of the fringe be applied to employee-only coverage on the lowest cost plan that provides minimum value. Depending on design, the remainder could be used to purchase a different tier of coverage, a buy up option providing richer coverage or elect another bona fide fringe benefit. A cash out is likely not an option due to the constructive receipt issue.

What are recommended SCA Pay or Play action items for affected employers?

- Consider possible business challenges associated with the recommended approach.
- Are any of the SCA employees who would be impacted by a change in the SCA fringe payment protocol covered under a collective bargaining agreement? If so, this may need to be added to a list of items to be negotiated with the applicable unions, as existing agreements may specify how any SCA fringe payment is to be made.
- Would a change in the SCA fringe payment protocol adversely impact business operations? Many SCA employees have become accustomed to having the choice between cash or benefits, and forcing coverage may be unpopular with certain employee segments – particularly those who may already have access to minimum essential coverage through a governmental program (e.g., Tricare, Medicare, etc.) or a spouse.
- Is there any adverse cost impact? In most cases, a change in how the SCA fringe is paid will be cost-neutral. However, in the event that an SCA employee has not accrued a sufficient SCA fringe payment to cover the cost of self-only coverage, there could be an adverse cost impact since the employer may need to make up any shortfall before forcing an election for coverage. (Requiring the shortfall to be paid from the employee’s wages may create issues under local wage and hour laws).
- Consider whether alternative approaches are viable. More risk-tolerant clients who face the above challenges may feel it is worth considering other strategies. One approach may be to simply treat the SCA fringe payment as an employer contribution since there is a lack of direct guidance addressing the issue. Industry experts have written the IRS recommending
this approach, but to date, regulators have not responded to this recommendation. At least one third party administrator has taken the position that an SCA employer may still offer the choice between cash or coverage on the basis that SCA fringe payments should be deemed “employer-directed” and therefore bypassing the constructive receipt issue. Clients considering these alternatives will want to discuss potential client risks, as well as business advantages, with independent legal counsel.

- Update plan documents (e.g., SPDs, cafeteria plan documents) as required to address any changes in how the SCA fringe payment is administered.