

Publications

Recent Trend in Health Care: Defined Contribution Health Care Arrangements

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Employers who are concerned about rising costs and the increasing administrative complexities of providing health coverage for employees have been exploring new ways to structure health care arrangements. Many employers are currently exploring the pros and cons of arrangements frequently referred to as “defined contribution health care.” Such arrangements may be structured in any of the following ways:

The employer provides active employees a high deductible health plan coupled with an account (either funded or unfunded) that can be used to pay medical expenses up to the amount of the deductible, or medical expenses that are not covered by the insurance. Amounts that are not used in one year may be carried over to the next. The employer provides active employees with a fixed amount of money to be used toward the purchase of one of several employer-selected health insurance options. The employee decides which option to purchase. If the option selected by the employee is more expensive than the fixed amount of money, the employee makes up the difference. If the option selected by the employee costs less than the fixed dollar amount, the excess is set aside in an account for the employee to use for medical expenses.

The employer offers retirees medical coverage through an account-based plan in which employees accumulate funds while they are active, but only use the funds when retired. The contributions may come directly from the employer, or alternatively, may come from some type of severance arrangement that the employee gets upon separating from service (including unused vacation or sick leave) or possibly even be funded solely by after-tax employee contributions.

The advantages of these types of arrangements from an employer’s perspective include the ability to predict health care costs, to reduce time spent negotiating with insurers, and to potentially avoid having to comply with certain existing and proposed federal health laws. Employees have the advantage of being able to exercise more control over decisions. From a health policy perspective, cost containment, cost predictability and more choices for employees should all be viewed favorably by the government. However, critics of these arrangements argue that although there may be initial health cost savings for employers, the arrangements will not ultimately result in cost savings on a long-term basis. In addition, some believe that the arrangements are the first step in leading employees away from group coverage, causing individuals to

lose the benefit of the employer's risk pool and administrative support in buying health insurance, both of which give the employee better coverage at lower rates.

The government is in the process of weighing these policy pros and cons, and has yet to endorse any of these arrangements. The IRS announces each year in a Revenue Procedure that it will not issue rulings in certain areas. For several years, including this year, the IRS has announced that it will not rule on whether an employer-funded medical reimbursement plan that allows unused amounts to be carried over and accumulated in an employee's account qualifies as an accident or health plan under section 105 of the Code (Rev. Proc. 2002-3, I.R.B. 2002-1). Accordingly, in addition to deciding whether such an arrangement makes sense from a business perspective, employers must also assess the risk that the arrangement may generate adverse tax consequences. Significant issues to analyze include:

Whether the arrangement is a Flexible Spending Account subject to various IRS rules such as "use it or lose it", the application of which would prevent amounts from being carried over from year to year.

Whether the arrangement should be funded in a trust or other arrangement, including possible ERISA and tax implications.

Whether the arrangement can be used to pay for any of the items that are medical expenses under the Code, including insurance premiums.

Whether unused amounts may be used for coverage of dependents, death or severance payments.

Whether the arrangement complies with the nondiscrimination rules for self-insured medical plans under the Code.

Whether the arrangement complies with the HIPAA health factor non-discrimination rules under the Code and ERISA.

Whether the arrangement is subject to COBRA, and if so, how to calculate applicable premiums.

If you are considering whether to adopt this type of arrangement, Groom Law Group can provide advice about these issues and recommend ways to structure the arrangement intended to comply with laws and regulations.