Defined Contribution Health Plans in California

Due to the annual cost increases associated with traditional employee health benefits, a new form of health benefits, called a defined contribution health plan, is quickly gaining popularity in California. Defined contribution health plans allow California employers to offer health benefits to employees without offering a traditional group health insurance plan.

Rather than paying the costs to provide a specific group health plan (a "defined benefit"), California employers instead fix their costs by establishing a monthly dollar amount (a “defined contribution”) that employees choose how to spend. Employees participating in a defined contribution health plan in California can request tax free reimbursement for their out-of-pocket medical costs and personal health insurance expenses.

Recruiting and retaining key employees is important to every company and a company’s health benefit program is a critical part of the compensation it offers to its employees.

The general concept of a defined contribution health plan in California is that a company gives each employee a fixed dollar amount that the employees choose how to spend. Typically, employees are allowed to use their defined contribution to reimburse themselves for individual health insurance costs or other medical expenses such as doctor visits and prescription drugs.

Defined contribution health plans in California are programs that allow employees to be more involved in their health care choices.

How Defined Contribution Health Plans Work in California

In California, employers must use an ERISA and HIPAA-compliant platform to administer a defined contribution health plan to avoid compliance issues.

The federal government has guidelines for California employers who want to contribute to an employee’s individual health insurance costs. Specifically, the employer must take special steps to avoid "employer endorsement" of the individual plans.

To avoid endorsement of individual health insurance plans, California employers:

1. Must not be involved in an employee’s decision to purchase individual health insurance, or their decision on which California insurer or plan to use. They must not get involved in any negotiations with a California insurance carrier over price or benefits of individual health insurance plans, and must not provide employees with claim forms or other materials related to their individual health insurance policies.
2. May not directly pay premiums on individual health insurance policies. They must not receive any compensation from a California insurance carrier in connection with an employee’s individual health insurance policy.
3. Must not become involved in any claim dispute between an employee and a California insurance carrier; all inquiries must be directed to the insurer.

To comply with (1) above, while still making contributions to a defined contribution health plan in California that can reimburse for individual health insurance premiums, employers should follow these additional guidelines:

1. California employers must not pressure employees to use the defined contribution to pay for individual insurance coverage.
2. In addition to reimbursing for health insurance premiums, California employers should also allow the use of funds for qualified medical expenses.

3. California employers must limit their role to simply verifying that a qualified medical expense (such as an individual health insurance premium) was incurred, and then reimbursing such amount from the defined contribution.

Benefits of Defined Contribution Health Plans in California

Generally, the benefits of a defined contribution health plan in California include:

1. *Employee Choice* - employees choose a health insurance plan based on their personal needs.
2. *Fixed Cost* - employers fix their health insurance costs by defining fixed monthly contributions.
3. *Savings* - defined contribution health plans typically cost less than group health insurance plans, resulting in savings for the employees and employer.

With a defined contribution health plan in California, an employer may choose to give employees different contributions based on classes of employees. Federal regulations state that “a plan or issuer may treat participants as two or more distinct groups of similarly situated individuals if the distinction between or among the groups of participants is based on a bona fide employment-based classification consistent with the employer’s usual business practices." Additional employer guidelines consist of the following:

- Bona-fide business differences may include job categories, geographic location, part-time or full-time status, date of hire, etc.
- Treat all “similarly situated” employees equally. By creating classes based on genuine job categories, all employees within a class will be “similarly situated”.
- Do not discriminate against unhealthy people. An employer cannot provide inferior benefits to specific individuals with adverse health conditions.
- Spell out the requirements for classes and benefits in the plan document. If, upon audit, a defined contribution plan is found to not comply with these rules, then the employer must provide the same level of benefits to all employees, regardless of their class, from the time the plan was created to the date of the violation.

Frequently Asked Questions about Defined Contribution Health Plans in California

Are Defined Contribution Health Plans Legal in California?

Yes. Defined contribution health plans are 100% allowed in California if administered properly. Nothing in California insurance code restricts an employer (small or large) from offering a defined contribution health plan that reimburses employees for individual health insurance plans.

Why Can't Employers Just Pay Directly for Employees' Individual Health Insurance Plans in California?

Some companies may want to pay directly for its employees’ individual health insurance plans without utilizing an IRS, ERISA and HIPAA-compliant defined contribution health plan, but doing so will put the employer out of compliance with federal regulations and increase the employer’s (and employee’s) tax liability.

There are two major reasons an employer should never pay for its employees’ individual health insurance plans:

1. Federal Compliance Issues
2. Increased Tax Liability

1. Federal Compliance Issues

<u>Paying for individual health insurance in California without an ERISA and HIPAA-compliant defined contribution health plan causes the employer to "endorse" the individual health insurance plans</u>

When a California employer pays directly for an individual health insurance plan, they effectively endorse each employee’s individual insurance plan as part of an employer-sponsored group health benefit offering. In other words, according to federal law, the employer is treating the individual plan as part of an employee welfare benefit plan regulated by ERISA. Because most individual health insurance plans do not meet all ERISA group plan requirements, the employer is out of compliance.

Separately, an employer is not allowed to know the details of employees' HIPAA-protected medical expenses. Because most individual health insurance costs are based on an employee's health due to medical underwriting, the health insurance details must be HIPAA protected. When an employer pays for the individual policy, they can violate HIPAA-privacy requirements if they know the details of a HIPAA-protected employee expense.

The federal government has guidelines for employers who want to contribute to employee's individual health insurance premiums without violating the HIPAA and ERISA regulations. An ERISA and HIPAA-compliant defined contribution health plan will ensure compliance with federal law.

2. Increased Tax Liability

Paying for individual health insurance in California without an IRS-compliant defined contribution health plan causes the payments to become taxable income to the employees

If an employer pays for employees' individual health insurance premiums in California without utilizing an IRS-compliant defined contribution health plan, such payments must be reported as taxable income to the employees.

The IRS requires that legal plan documents be established in order for California employees to deduct the individual health insurance premiums from taxable income on the annual W-2.

An IRS-compliant defined contribution health plan will ensure the tax deductibility of employee's individual health insurance premiums.

Are there Minimum Participation or Contribution Requirements in California?

In California, there are no minimum or maximum contribution requirements that a California employer must contribute to an employee's defined contribution health plan. The employer may choose the dollar amount they wish to contribute to an employee, ranging from $0 to an unlimited amount per month.

Similarly, there is no minimum employee participation requirement that an employer must meet in order to offer a defined contribution health plan. A defined contribution health plan may be offered by an employer of any size in California, even of only one employee chooses to participate.

What Types of Expense Are Eligible for a Defined Contribution Health Plan in California?

In California, a defined contribution health plan may reimburse any expense considered to be a qualified medical expense by the IRS, including premiums for individual health insurance plans. It is also important to note that employers may restrict the list of reimbursable expenses in any way they choose.

For more information on reimbursement of medical expenses in California, please refer to IRS Publication 502.