

# Defined Contributions Explained

## *What Are They and Why All the Fuss about Them?*

**Employers are frustrated** with the increasing costs and the responsibility of providing medical benefits to their employees. In order to reduce costs and minimize their burden for controlling costs, some employers are moving toward a “defined contribution” approach.

**The Defined Contribution approach** (i.e., limiting the employer’s liability by capping or redistributing its health care benefit subsidy) **may take many different forms including:** Taxable Subsidy, Premium Reimbursement, Cafeteria Plan, Medical Savings Accounts, Health Care Accounts (HCA), and HCAs with High Deductible Health Insurance. Most of these have been around for many years, but the form getting the most attention right now is **HCAs with High Deductible Health Insurance – this is also known as “Consumer Directed Health Plans” (CDHPs).**

### **In general, here is how a CDHP works:**

An employer offers a CDHP to employees in the form of a high deductible (e.g., \$1,000) indemnity or PPO-style medical plan. In addition, those who enroll have a personal Health Care Account (HCA) set up for them. The employer funds this HCA, theoretically with money saved through the purchase of the high deductible health plan. The employee and their dependents may use the money in the HCA to help pay for out-of-pocket health care expenses. HCA contributions are not considered taxable to the employee if used for qualified health care expenses. Another up side to an HCA is that money in the account may accrue interest.

**The popularity of the CDHP approach has increased, in large part, due to IRS Guidance** issued in 2002 that approved the year-to-year rollover of tax-qualified employer contributions to personal HCAs -- as long as contributions are used only for qualified medical expenses and plan premiums and don’t include pre-tax payroll deductions.

### **Advantages and Disadvantages of CDHPs**

ADVANTAGES	DISADVANTAGES
Limits employer liability	If offered alongside current plans will likely generate less than 10% participation and very little short-term savings
Could lead to long-term cost reduction if designed properly	HCA is forfeited at termination of employment
Introduces another option that may be better tailored to meet employees’ health care needs	New (and somewhat uncharted) communication, administration, and regulatory compliance complexities emerge A CDHP may not be offered in a Cafeteria Plan

## Items to Consider

**Plan Design:** How will the plan be constructed? Will it be offered alongside current offerings?

**Pricing:** What will the plan cost? What will employees contribute in order to participate? What will the employer contribute to the HCA? How can adverse selection be minimized?

**Funding:** Will the plan be fully insured or self-funded? Who will administer and monitor the HCAs?

**Communications:** What level of responsibility does the employer believe it has to educate employees about their alternatives? What tools will be available an employer make available to help employees to make health care decisions?

**Administration:** What is the expected workload related to this new option? Who is going to administer claims, eligibility, spending accounts, compliance, etc.?

### **What are the Legal and Regulatory Compliance requirements?**

What are the tax risks? IRC Section 105 & 125 along with Health FSA rules, HIPAA, COBRA, and ERISA must be addressed.

### **Are CDHPs something you should think about?**

Don't be misled by the claim made by some that CDHPs will result in considerable cost reduction.

- Unless a CDHP is a complete replacement for all current medical options, there is little likelihood for meaningful short-term cost reduction.
- Cost reduction is a function of enrollment, and CDHPs offered alongside other options, are not getting the enrollment that generates much savings.
- CDHPs, if offered alongside current options, provide an opportunity for long-term cost control.

They introduce many challenges and considerations.

- Plan design and pricing
- Communication and administration
- Legal

## **Marsh Consulting Group (MCG) recommends ...**

- The mid-size employer (250+ employees) let the small group market and Fortune 500 companies work through the kinks of this approach before embarking (similar to how they did the Cafeteria Plan and Point-of-Service approaches when they were first introduced).
- Defined Contribution in the form of a Cafeteria Plan (or “full flex” program) along with other cost control approaches (e.g., modifying funding arrangements, consolidate risk pools, etc.) be considered first or in conjunction with the CDHP approach.

MCG works closely with mid-size and large employers throughout the U.S. to develop, communicate, manage, and measure successful employee health care cost control strategies.

Please call MCG with your questions or comments regarding Defined Contribution Health Plans.

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