# HEALTH CARE REFORM: EXCISE TAX ON HIGH-COST EMPLOYER HEALTH PLANS

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One of the most hotly debated provisions of the Affordable Care Act (ACA) is the addition of Section 4980I to the Internal Revenue Code (IRC), which imposes a 40 percent Excise Tax (also called the "Cadillac Tax") on high-cost employer health plans. Although the Excise Tax will not be imposed until **2020**, it may have a substantial effect on the cost of employer-sponsored health plans; therefore, employers should take steps now to evaluate and minimize the potential impact of the tax on their benefits programs.

To date, the Department of the Treasury has not issued regulations or guidance on IRC Section 4980I and, as a result, there are quite a few open questions about how IRC Section 4980I will apply in practice. This *Briefing* lays out what we currently know based on the statutory language along with some possible strategies for minimizing the impact of the tax.

## BACKGROUND

The purpose of the Excise Tax is threefold: (1) to help fund the costs of the ACA, (2) to assist with slowing the rate of growth of health care costs, and (3) to address the unequal tax treatment of employer-sponsored health coverage. Many proponents of the Excise Tax believe that "rich" benefits shield employees from the true cost of health care and encourage the overutilization of health care services. They also argue that excluding the value of employer-provided health coverage from an employee's taxable income results in unequal tax treatment that favors higher income employees with high-cost employer plans. This is because employees with higher incomes get a larger tax break than lower income employees with low-cost health plans. It is estimated that the current income tax exclusion for individuals with employer provided health coverage "costs" the government approximately $250 billion annually. Any attempt to eliminate the income tax subsidy would be met with extreme opposition, so the Excise Tax is viewed by the drafters of the ACA as a reasonable compromise. Most affected employers and their employees would probably disagree.

## WHO IS LIABLE FOR THE TAX?

The Excise Tax applies to fully insured and self-funded plans for both active employees and retirees. For fully insured plans, the insurer will pay the tax on its share of the "excess benefit." Although there is no requirement for insurers to pass on the cost of the tax to employers, it is certainly expected that they will do so. For self-funded plans, IRC Section 4980I(c)(2)(c) states that "the person that administers the plan benefits" will be liable for the tax, but the term is not clearly defined. It is likely that it will be the plan sponsor (usually the employer) who is liable for the tax.

**Note: The tax originally was non-deductible for federal income tax purposes; however, the Consolidated Appropriations Act, 2016 that extended the effective date until 2020 also made it easier for some employers to deal with the expense of the Cadillac Tax by making it a deductible business expense.**

## Calculating the Tax

The Excise Tax is 40 percent of the aggregate cost of health care benefits over certain dollar thresholds (also called the "excess benefit"). The initial thresholds for **2020** are $10,200 for self-only coverage and $27,500 for family coverage (i.e. any coverage tier other than self-only). The Excise Tax applies to the aggregate cost above the tax thresholds. For example, if the cost for self-only coverage is $12,000, the tax would be 40 percent multiplied by $1,800 ($12,000 – $10,200) or $720 per covered employee.

The plan costs include the core medical benefits, prescription drugs and "carve-out" plans such as Behavioral Health, Employee Assistance Programs, chiropractic, as well as onsite medical clinics that provide significant benefits in the nature of medical care or treatment. The statutory language excludes fully insured stand-alone dental and vision plans but it is unclear whether the exclusion will also extend to self-funded plans. It is anticipated that regulatory guidance will address this question.

The cost of coverage includes employer contributions for medical benefits *and* employee contributions. In addition, employer and employee contributions to health Flexible Spending Accounts (FSAs), Health Reimbursement Accounts (HRAs) and Health Savings Accounts (HSAs) are included. Deductibles and copays are not included in the cost calculation.

## Adjustments to the Annual Limits

There are several adjustments that may be made to the annual threshold limits. For pre-65 retirees and individuals in high-risk professions (e.g. law enforcement, fire protection and construction), the thresholds are higher. The expected **2020** limits for these individuals are $11,850 for self-only coverage and $30,950 for family coverage. In addition, multi-employer plans (e.g. a Taft-Hartley plan) may apply the $27,500 limit to all tiers, including self-only coverage. This exception does not apply to Joint Powers Authority programs (JPAs) since they are not multi-employer plans as defined under the Employee Retirement Income Security Act of 1974 (ERISA). In addition, the following adjustments will be made either to the initial **2020** thresholds or on an ongoing annual basis:

**Health Cost Adjustment** – For **2020**, the Excise Tax thresholds will be adjusted upwards if the cost of the federal Blue Cross/Blue Shield (BCBS) standard benefit in 2010 increases by more than 55 percent from 2010 to 2018. However, the cost increases for the federal BCBS plan have been minimal since 2010, so it appears unlikely that the 55 percent increase threshold will be met. Therefore, the $10,200 and $27,500 limits are likely to hold for **2020**.

**Age and Gender Adjustment** – For **2020** and beyond, the annual dollar limits will be adjusted to account for age and gender. The adjustment will not be a percentage but rather a dollar amount that will be added to the annual limit. It is anticipated that the Department of the Treasury will provide guidance on this adjustment in the form of tables or formulas.

**Consumer Price Index Adjustment** – In **2021**, the limits will be indexed to the Consumer Price Index-Urban (CPI-U) plus one percent and rounded to the nearest $50. For **2022** and beyond, the annual limit will be indexed to the CPI-U and rounded to the nearest $50. Because the rate of health care inflation is expected to be considerably higher than the CPI-U, the amount subject to the tax is expected to increase significantly over time (assuming employers do not make plan adjustments to avoid the tax).

## Who Calculates the Tax?

Responsibility for calculating the tax falls on the employer. In addition, the employer must determine the share that is attributable to each coverage provider, if there is more than one. After calculating the tax and determining each coverage provider's share, the employer must report the amount due to each coverage provider and to the Department of Treasury in a manner that will be determined by future regulatory guidance. For multi-employer plans, the obligation to calculate and report falls on the plan sponsor.

If an employer inaccurately calculates the amount each coverage provider must pay and, as a result, the coverage provider underpays the tax, the coverage provider will not be subject to a penalty but it must pay the additional tax owed. However, the employer who miscalculated the tax will be subject to a penalty equal to 100 percent of the additional tax plus interest.

## Employer Strategies to Minimize the Tax Impact

Although the Excise Tax is not effective until **2020**, it is critical for employers to address the potential impact to their benefit programs. The most obvious approach is to reduce plan benefit levels so that the projected plan costs are under the **2020** limits. Deductibles and copays do not count toward the cost of the plan, so increasing these are the "easiest" way to reduce costs; although, with collectively bargained employees, this is easier said than done. Employers should try to maintain bargaining agreements that are flexible enough to accommodate ACA mandates and to make benefit changes that will minimize the impact of the Excise Tax. Employers should also explore alternative plan design options that help lower the overall cost.

The adoption of High-deductible Consumer Directed Health Plans (CDHPs) is another approach many employers are considering. CDHPs hold the promise of lower premiums and lower trend as the consumer is more actively engaged in the management of their own health care than under traditional plans.

Other approaches include implementing narrow-network models, Accountable Care Organizations (ACOs), reference-based pricing for certain procedures and enhanced Population Health Management, including Wellness and Chronic Condition programs. Employers should also examine their tier structure to determine if a reallocation of the tiers may help avoid or reduce the Excise Tax.

## Will the Tax be Repealed or Modified?

Although the Excise Tax is very unpopular with employers and labor, there is currently no legislation pending that proposes to eliminate or modify the tax. There is strong sentiment among employers, labor organizations, and many politicians to change the legislation and we expect there will be attempts to do so over the next year or two; but for now, the Excise Tax is scheduled to go into effect in **2020** and employers should not wait to plan for the tax's impact.

Please contact your Keenan HealthCare Account Manager for questions regarding this *Briefing* or if you require any additional information regarding the Affordable Care Act.