Looking Under the Hood—
Top Five Open Issues for the Cadillac Tax

The Affordable Care Act’s “Cadillac tax” on high-cost group health care plans begins in 2018, yet its expected impact on employers remains an open question. Clarifying regulations, guidance and potential statutory changes between now and then will determine whether employers find the tax to be even more of an administrative burden than a financial one. This article discusses the top five open issues about the application of the tax and its administrative requirements, encouraging employers to use caution in making strategic decisions in advance of clarifying regulations and potential statutory changes.

by Richard Stover | Buck Consultants at Xerox and Leslye Laderman | Buck Consultants at Xerox

Starting in 2018, the Affordable Care Act (ACA) will impose a 40% excise tax on high-cost group health care plans. This tax—commonly called the “Cadillac tax”—has consistently appeared at the top of the list of employer concerns in various surveys. While many employers are already acting to mitigate its impact, there are still some important open questions about the application of the tax and its administrative requirements. Depending on the answers to these questions, the tax will not only be a significant financial burden for many employers, but it may be an even more significant administrative burden. This article will take a brief look at the top five open issues.

1. What Is “Employer-Sponsored Coverage”?
The Cadillac tax applies to the cost of “applicable employer-sponsored coverage” that exceeds certain thresholds.

Applicable employer-sponsored coverage includes not only group health plans providing benefits to active employees but also retiree medical plans and other arrangements providing health benefits to employees, such as:
- Health reimbursement arrangements (HRAs)
- Employer contributions to health savings accounts (HSAs)
- Employee pretax contributions and employer contributions to health care flexible spending accounts
- Executive physical programs, if not subject to taxation.

Additional guidance is required to clarify how certain benefits are treated for purposes of the Cadillac tax:
- Employee pretax contributions to HSAs—“Employer contributions” to HSAs constitute “employer-sponsored coverage,” even though HSAs gen-
eraly are not considered health benefits for other purposes under ACA. However, the treatment of employee pretax HSA contributions is not clear. If employee pretax contributions are treated as employer contributions and taken into account in determining whether the applicable threshold is met, many employers may either cap or eliminate employee pretax contributions. While employees can make after-tax contributions to HSAs and deduct those contributions, this likely would still have a negative impact on HSAs.

- **Dental and vision plans**—The law states that “employer-sponsored coverage” does not include dental and vision coverage provided “under a separate policy, certificate or contract of insurance.” The status of self-insured dental and vision plans is uncertain. Unless regulators exempt these dental and vision plans from the tax, employers may need to eliminate these benefits, to avoid the tax, or insure the benefits, resulting in additional costs.

- **Employee assistance programs and on-site clinics**—These benefits are treated as employer-sponsored coverage if they are considered to be group health plans. The rules for that determination will be important.

- **Expatriate plans**—Due to the challenges that expatriate plans have in complying with many ACA requirements, insured expatriate plans have received a temporary exemption from many of the ACA provisions. However, current guidance does not address the Cadillac tax.

2. **How Is the “Aggregate Cost” Determined?**

The Cadillac tax will be imposed on the amount by which the “aggregate cost” of employer-sponsored coverage exceeds the applicable dollar limits. Aggregate cost includes both the employer- and employee-paid portions of the cost. That cost is “determined under rules similar to” Consolidated Omnibus Budget Reconciliation Act (COBRA) rates. For insured plans, the premium rate is used for COBRA. However, even though COBRA was enacted in 1985, only limited guidance exists on how COBRA rates are determined for self-insured plans, beyond the requirement that COBRA rates be determined on an actuarial basis.

Numerous actuarial and underwriting factors are used to set COBRA rates, including the claims period, credibility, trend, margin, tiering, pooling of large claims and plan design adjustments. There are a wide range of reasonable (and not-so-reasonable) assumptions that can be used for each of these factors. Currently, employers have an incentive to be conservative with these assumptions in order to charge the highest justifiable COBRA rate. Now, with the Cadillac tax, employers have an incentive to be as aggressive as possible in setting low COBRA rates.

Given the significantly increased use of COBRA rates as an ACA revenue raiser, it seems likely that either COBRA rate guidance will be issued or regulators may require an actuarial certification of COBRA rates, similar to what is done currently for asserting actuarial equivalence of prescription drug coverage for purposes of the Part D retiree drug subsidy. As an alternative, safe harbor assumptions or underwriting guidelines may be provided.

3. **How Will the “Age and Gender Adjustment” Work?**

The Cadillac tax is paid on the aggregate cost of coverage in excess of the 2018 statutory thresholds of $10,200 for self-only coverage and $27,500 for other than self-only coverage. These thresholds are subject to a number of adjustments, including higher thresholds for retirees between 55 and 64 and plans where the majority of employees are in high-risk occupations. Importantly, no adjustments are made for geography, high-cost claimants or plan design.

However, there is an important adjustment that will benefit employers with age and gender characteristics that vary from the national workforce. For example, if the average national workforce is aged 41, an employer with an average age of 44 or 45 could have a significant upward adjustment in the cost thresholds and, therefore, pay a lower tax. Similarly, an increase in the thresholds could result if the employer’s gender characteristics vary from the national workforce. Typically, this would apply for employers with a higher per-
health care reform "lookback"

What Benefits Are Not Subject to the Cadillac Tax?

The Cadillac tax won’t apply to these benefits:

- Insured dental and vision plans
- Fixed indemnity, hospital indemnity, dread disease and similar plans paid for by employee on after-tax basis
- Long-term care
- Accident and disability benefits
- Workers’ compensation
- Auto insurance.

However, the 40% excise tax would be applied to flexible spending accounts (FSAs). As an employer’s plans approach the Cadillac tax limits, health FSAs likely would be one of the first benefits dropped.

4. Who Is a “Coverage Provider”?

The employer is required to determine the amount of the Cadillac tax on a monthly basis and then allocate that tax among “coverage providers.” This monthly calculation and allocation will be an onerous process, particularly depending on how coverage provider is defined.

The law specifies that the coverage provider for insured health coverage is the insurer and that the employer is the coverage provider for HSA contributions. For all other coverages, including self-insured plans, the coverage provider is “the person who administers the plan benefits.” If that definition means that the third-party administrator (TPA) or pharmacy benefits manager (PBM) is the coverage provider, an employer with a self-insured plan would need to allocate the excise tax among multiple vendors. For example, an employer with a health care flexible spending account, a medical TPA and a carve-out PBM would need to allocate the excise tax among those three providers each month, a cumbersome process. Alternatively, if the regulators define the coverage provider for self-insured plans as the ERISA plan administrator or employer, the administration of the tax will be greatly simplified for large employers. For employers with no insured plans, no allocation to other coverage providers would be needed.

Which leads directly to the last open issue.

5. When Is 40% Really 60%?

The Cadillac tax is a nondeductible excise tax, which increases the cost impact on for-profit employers. But who pays the tax can further aggravate the cost impact on employers.

For insured plans, insurers likely will build the excise tax into the premium rates they charge employers. Since premium payments are income to insurers, the premium will be taxable to for-profit insurers. Therefore, insurers will need to “gross up” the amount of the excise tax they include in the premiums so that—after taxes—they have the 40% excise tax amount available to pay the federal government. For example, assuming a 35% corporate tax rate, effectively the insurer needs to include a 60% excise tax amount in the premium rates. So if the insurer has to pay an excise tax of $100,000 for an employer plan, assuming a 35% insurer tax rate, the insurer will need to include $154,000 in the premium rates. (Insurers already are making a similar tax adjustment for the health insurance provider’s fee, which was effective in 2014 for insured plans.)

If the coverage provider for self-insured plans is the TPA, PBM or flexible spending account administrator, for-profit providers will also need to gross up the amount they bill employers to cover the excise tax. While the excise tax is nondeductible to the coverage provider, these costs would likely be deductible by employers. Effectively, the employer would pay only the 40% amount after taxes. But employers that do not pay income taxes, such as governments and not-for-profits, would effectively pay a 60% Cadillac tax instead of 40%.

This tax treatment would result in inequitable treatment in the marketplace between employers and insurers that pay taxes, as opposed to those that do not. It certainly supports

percentage of female workforce than national averages. Importantly, this adjustment can only increase the thresholds and not reduce them.

What Benefits Are Not Subject to the Cadillac Tax?

The Cadillac tax won’t apply to these benefits:

- Insured dental and vision plans
- Fixed indemnity, hospital indemnity, dread disease and similar plans paid for by employee on after-tax basis
- Long-term care
- Accident and disability benefits
- Workers’ compensation
- Auto insurance.

However, the 40% excise tax would be applied to flexible spending accounts (FSAs). As an employer’s plans approach the Cadillac tax limits, health FSAs likely would be one of the first benefits dropped.

4. Who Is a “Coverage Provider”?

The employer is required to determine the amount of the Cadillac tax on a monthly basis and then allocate that tax among “coverage providers.” This monthly calculation and allocation will be an onerous process, particularly depending on how coverage provider is defined.

The law specifies that the coverage provider for insured health coverage is the insurer and that the employer is the coverage provider for HSA contributions. For all other coverages, including self-insured plans, the coverage provider is “the person who administers the plan benefits.” If that definition means that the third-party administrator (TPA) or pharmacy benefits manager (PBM) is the coverage provider, an employer with a self-insured plan would need to allocate the excise tax among multiple vendors. For example, an employer with a health care flexible spending account, a medical TPA and a carve-out PBM would need to allocate the excise tax among those three providers each month, a cumbersome process. Alternatively, if the regulators define the coverage provider for self-insured plans as the ERISA plan administrator or employer, the administration of the tax will be greatly simplified for large employers. For employers with no insured plans, no allocation to other coverage providers would be needed.

Which leads directly to the last open issue.

5. When Is 40% Really 60%?

The Cadillac tax is a nondeductible excise tax, which increases the cost impact on for-profit employers. But who pays the tax can further aggravate the cost impact on employers.

For insured plans, insurers likely will build the excise tax into the premium rates they charge employers. Since premium payments are income to insurers, the premium will be taxable to for-profit insurers. Therefore, insurers will need to “gross up” the amount of the excise tax they include in the premiums so that—after taxes—they have the 40% excise tax amount available to pay the federal government. For example, assuming a 35% corporate tax rate, effectively the insurer needs to include a 60% excise tax amount in the premium rates. So if the insurer has to pay an excise tax of $100,000 for an employer plan, assuming a 35% insurer tax rate, the insurer will need to include $154,000 in the premium rates. (Insurers already are making a similar tax adjustment for the health insurance provider’s fee, which was effective in 2014 for insured plans.)

If the coverage provider for self-insured plans is the TPA, PBM or flexible spending account administrator, for-profit providers will also need to gross up the amount they bill employers to cover the excise tax. While the excise tax is nondeductible to the coverage provider, these costs would likely be deductible by employers. Effectively, the employer would pay only the 40% amount after taxes. But employers that do not pay income taxes, such as governments and not-for-profits, would effectively pay a 60% Cadillac tax instead of 40%.

This tax treatment would result in inequitable treatment in the marketplace between employers and insurers that pay taxes, as opposed to those that do not. It certainly supports
defining the coverage provider for self-insured plans as the employer.

**Conclusion**

No regulations or guidance have been issued on the Cadillac tax, and the comments in this article are based on interpretation of the statute. Therefore, caution should be used in making strategic decisions in advance of clarifying regulations and potential statutory changes. While the effective date of the Cadillac tax is still several years away, employers need guidance soon for planning purposes on these important issues.