MARSH & McLENNAN AGENCY

# REFORM UPDATE

## THE CADILLAC TAX

The Cadillac Tax is a part of the Affordable Care Act (ACA). To date, the Internal Revenue Service (IRS) has issued two notices to request feedback from stakeholders:

- IRS Notice 2015-16 outlined a broad interpretation of how the Cadillac Tax might be implemented
- Notice 2015-52 acts as a supplement to Notice 2015-16. It provided more details and requested specific feedback from stakeholders

Both Notices provide insight into the future applicability of the Cadillac Tax. Ultimately, these Notices are a request for comment from stakeholders. These Notices and associated comments will be used by the IRS to draft future proposed and final regulations on the Cadillac Tax.

At the end of 2015, the Consolidated Appropriations Act was signed into law. This Act made two key changes to the Cadillac Tax:

1. Delayed the effective date to 2020 tax year
2. Changed the status of the tax from non-deductible to deductible as a business expense

These Notices merely provide the IRS's initial thoughts on the implementation of the Cadillac Tax. They should not be considered "Proposed Regulations" as there will likely be considerable changes when the actual proposed and final regulations are published. This memo merely outlines the Notice details which address the possible direction of future regulations. Organizations should consult their legal counsel for direct guidance.

### Background

#### CADILLAC TAX IN GENERAL – NOTICE 2015-16

Section 4980I(a) of the Internal Revenue Code imposes a 40 percent excise tax on the aggregate cost of coverage per month above the threshold applicable dollar limit for an employee for that month.

The aggregate cost of coverage is a broad term. Generally, the cost of coverage will include all coverage under any group health plan which is excludable from the employee's gross income (IRC Section 106). This means even account-based coverage such as HSAs, Archer MSAs, FSAs, and HRAs need to be included in the cost of coverage, unless they are received as an after-tax benefit by the employee.

The following is a list of "applicable coverage" (in addition to major medical plan coverage), that is subject to the Cadillac Tax:

1. Health FSAs
2. Archer MSAs (paid with pre-tax contributions)
3. HSAs (paid with pre-tax contributions)
4. Governmental plans
5. On-site medical clinics that provide more than minimal services
6. Retiree coverage
7. Multiemployer plans
8. Specified disease or illness plans/fixed indemnity plans (paid with pre-tax contributions)

The following is a list of coverage that is not considered "applicable coverage" under the Cadillac Tax:

1. Coverage for accident, or disability income insurance (or any combination thereof)
2. Coverage issued as a supplement to liability insurance
3. Liability Insurance, including general liability insurance and automobile insurance
4. Workers' compensation or similar insurance
5. Automobile medical insurance
6. Credit-only insurance
7. Secondary or incidental to other insurance coverage
8. Long-term care insurance
9. Coverage that substantially consists of either treatment of the mouth or eye; and
10. Coverage for specified disease or illness and fixed indemnity polices, paid for on a post-tax basis

The annual thresholds for 2018 will be $10,200 for individual coverage, and $27,500 for other than self-only coverage. All applicable coverage under a multiemployer plan is to use the "other than self-only coverage" threshold (For 2018 - $27,500). Note, these thresholds are annually indexed. The thresholds will be higher as of the 2020 effective date.

The 40 percent tax applies to the cost of coverage that exceeds the annual threshold. Cadillac tax liability will be paid by the "coverage provider" in the ratio that the coverage provider bears to the aggregate cost of all applicable coverage provided to the employee. With such a broad definition of cost of coverage, more than one coverage provider may be impacted.

Coverage providers are defined as the following:

A. The insurance issuer/provider that provides health insurance coverage
B. The employer, if such employer makes contributions to an employee's Archer MSA or HSA
C. The administrator of the plan (which may include the plan sponsor)
D. For all "other" applicable coverage, the coverage provider would be "the person that administers the plan benefits"

Employers are generally responsible for the calculation and determination of the excise tax. Please note that employers in the same Aggregated Controlled Group are treated as one single employer. Employers will also be responsible for allocating any applicable tax among coverage providers. Employers bear this responsibility, even though they may not ultimately be responsible for the payment of the excise tax. For multi-employer plans, if the plan sponsor is the multi-employer plan, the multi-employer plan will be responsible for the calculation and determination of the excise tax among coverage providers. Thereafter, a payment for the deductible excise tax (if applicable) will be made by each provider for the taxable period.

# NOTICE 2015-52 – REQUEST FOR COMMENTS

## Clarification on the Person that Administers the Plan Benefits

Where the coverage provider was not clearly defined in the Cadillac Tax legislation, but only defined as the "person that administers the plan benefits," the IRS sought comments on two potential approaches to defining that term:

1. The Administrator approach - The entity that completes the day-to-day functions of administering the plan should be considered the "person that administers the plan benefits." These duties include receiving and processing the claims, responding to inquiries, and the provision of a technology platform for the plan benefits information. In the case of self-funded plan, the administrator would typically be the Third Party Administrator (TPA).
2. The Sponsor approach - The entity who has ultimate authority or responsibility under the plan or arrangement over the administration of the plan benefits should be considered the "person that administers the plan benefits," even if they are not routinely involved with the plan. In the case of a self-funded plan, this is typically the employer.

The IRS requested comments on whether either of these categories would be easily identifiable as the responsible entity.

### EMPLOYER AGGREGATION RULES

Comments were sought on whether the application of the employer aggregation rules under IRC Section 414 (i.e. Aggregated Controlled Group rules) would create practical challenges in the administration of the Cadillac Tax rules.

### DETERMINATION PERIOD

Comments were again requested about the practical effects of the IRS calculating the cost of applicable coverage for Cadillac Tax purposes in a similar manner as calculating the COBRA applicable premium. Comments were also requested as to whether such calculation was even possible if the calculation of the applicable cost of coverage occurred after the taxable period. An example they provided was in relation to an employee's FSA account. If the cost of such coverage was calculated at the end of the calendar year, this may create practical challenges in assessing the Cadillac Tax because of the annual run-out period of the FSA.

### PAYMENT OF CADILLAC TAX DOES NOT ADD TO THE COST OF APPLICABLE COVERAGE

If a "person that administers the plan benefits" is an entity other than the employer, the Cadillac Tax will likely be passed on to the employer for payment of the tax. The IRS is seeking an approach whereby if the Cadillac Tax were added to the cost of coverage to an employer by the coverage provider, it would not then be counted toward the overall threshold cost of the plan. To avoid this situation, as long as these amounts are separately billed to the employer by the coverage provider, they would be excluded from the cost of coverage. However, the IRS proposes that if the Cadillac Tax is passed through to an employer by a coverage provider, that provider would pay an increased tax burden, as if they earned income on the passed

through cost of the Cadillac Tax to the employer. This may ultimately provide a way for the administrator to essentially find a way to "write off" the Cadillac Tax, even though it would normally not be a deductible expense.

The IRS requested comments on whether two different approaches could be potential solutions for a situation where a coverage provider did incur a tax burden for transferring the Cadillac Tax to an employer. Those two proposals would either have the coverage provider be attributed income at their specific marginal tax rate or create a standard marginal tax rate for all coverage providers for the attributed income.

## ALLOCATION OF CONTRIBUTIONS TO ACCOUNT-BASED PLANS

Generally, the cost of medical coverage that is excludable as income to an employee would count towards the cost of coverage. The cost of such coverage would be calculated on a per month basis over the taxable period. There is an exception to the "excludable from income" rule that applies to highly compensated employees covered by a discriminatory self-funded plan. The value of the discriminatory benefits must be treated as imputed income to the highly compensated employee. Therefore, the cost of discriminatory benefits to a highly compensated employee is included in their cost of coverage, despite being included as taxable income to that highly compensated employee.

Because some account-based coverages (e.g. FSA, HSA) may allow for contributions by the employee up to the maximum amount in the beginning of the plan year/calendar year, the IRS requests comments on whether such contributions should be allocated over a pro-rata basis over the course of the taxable period.

## COST OF APPLICABLE COVERAGE FOR FSAS WITH EMPLOYER FLEX CREDITS

The IRS proposes that if an employer contributes non-elective flex credits to an FSA, the cost of coverage that would be attributable to the FSA would be limited to those amounts that were actually reimbursed to the employee from the employer contributions made in excess of the employee's contributions to the FSA. This would be based upon a valuation of the cost of coverage at the end of the taxable year. If any employer contribution amount was rolled over into future years, those reimbursed amounts would be accounted for in future years.

## AGE AND GENDER ADJUSTMENT TO THE DOLLAR LIMIT

Although individual and small group plans may not adjust rates based upon the gender of a participant, the IRS recognizes that gender still impacts groups on an aggregate pricing basis. In addition, the IRS does recognize that age also accounts for pricing adjustments to a health plan.

Because of these factors, the IRS has proposed to allow for some adjustments to the threshold amount, based upon the demographics of specific employers. These employers typically have more expensive plans due to gender and age disparities from other parts of the nation. The IRS proposes comparing he Current Population Survey as summarized in Table A-8a, Employed Persons and Employment Population Ratios by Age and Sex, Seasonally Adjusted (hereinafter referred to as Table A-8a) to an employer's snapshot of employees on the first day of the plan year, to determine if age and gender adjustments should be made. Comments are requested on this approach to determine potential age and gender adjustments to the dollar limit.

In addition, a second more developed option may be available in future years. This approach would compare the following data points:

A. The average cost of coverage in the Federal Employees Health Benefits Program (FEHBP)

B. The average cost of coverage in plans for each age and gender group

C. The ratio of the FEHBP cost as compared to the general average cost of coverage

D. The national premium cost; and

E. The employer's premium cost

All of this data would be compared with one another and then used to determine whether a specific employer was entitled to an upward adjustment to its coverage cost threshold. This adjustment would be allowed due to the cost of coverage being higher than the national premium cost as a result of the age and gender mix. No downward adjustments will be permitted.

## Summary

These two IRS Notices attempt to put some structure around the application of the Cadillac Tax to benefit plans. They emphasize how complicated it can get determining the cost of coverage. There are indications that other possible solutions are being discussed. It is apparent that only more time and more comments will help to fill in the gaps created by this piece of legislation. Even with a delayed effective date, employers need to be mindful of the possible implications of the Cadillac Tax. Employers should begin monitoring the cost of the coverage that is being offered, as well as employer and employee contributions made to account-based programs. Employers may want to start considering plan or account changes now to mitigate potential exposure in 2020 to the Cadillac Tax.

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