



# BENEFITS PERSPECTIVES

Current Issues in Employee Benefits

## The ACA Cadillac tax: A primer for employers

Rob Pipich, FSA, MAAA | Chris Ruff, FSA, MAAA

Since its passage in 2010, the Patient Protection and Affordable Care Act (ACA) has garnered public attention for both its most notable features and the legal and political battles that have ensued. At this point, the concept of the individual mandate is well known, and the recent federal appeals court decision on the premium subsidies made available through the law that is now under review by the U.S. Supreme Court is at the forefront of public attention.

Though ultimately passed on to consumers through health insurance premiums or premium equivalents, much of the law's expenditures are paid for by insurance and pharmaceutical companies. Several other funding sources of varying size exist, and these less significant sources tend to impact smaller subsets of the population. The excise tax on high-cost insurance plans, often referred to as the "Cadillac tax," is one of these more narrowly targeted sources of funding that, although not as far-reaching as the insurer and pharmaceutical industry taxes, is projected by the Congressional Budget Office (CBO) to be a significant source of revenue.

### Background

The Cadillac tax is an excise tax beginning in 2018 on the cost of certain health coverage that exceeds a specified benchmark. When the ACA was enacted in 2010, the CBO projected that from 2010 to 2019, the tax would generate \$32 billion in revenue, all of which would be generated in 2018 and 2019. Of course, while the projection for 2018 and 2019 has been revised downward, the tax is likely to increase over time and is more significant in the CBO's recent projections that include additional years in which the tax is collected (e.g., a March 2015 update estimates that the tax will generate \$87 billion from 2016 to 2025).

The revenues generated are used to offset the cost of the ACA's expenditures, the largest of which include premium and cost-sharing subsidies, Medicaid expansion, and small-employer tax credits. A secondary impact of the tax is that it serves as a deterrent against the purchase of high-cost healthcare coverage.

### Tax amount and threshold

The law imposes a 40% excise tax on the cost of employer-sponsored health coverage that exceeds a benchmark threshold. The law does not assess the tax until 2018, but it included the starting thresholds of \$10,200 for self-only coverage and \$27,500 for other-than-self-only coverage (and all coverage under multiemployer plans) based on 2010 assumptions about health coverage costs in 2018. Thus, the amounts are first adjusted based on inflation in the Federal Employee Health Benefit Plan's (FEHBP) Standard Plan over this period relative to a benchmark 55% cost increase. Additionally, the threshold is adjusted upward for non-Medicare-eligible covered retirees aged 55-64, as well as for certain plans where the majority of employees are deemed to be in high-risk professions.

The resulting amount is then indexed to the Consumer Price Index for All Urban Consumers (CPI-U) starting in 2019, with an additional 1% inflation amount applied in 2019. Finally, there is an adjustment for employers whose employee age/sex mix is more costly to insure than an average national population. Notably absent from the threshold calculation is any adjustment for medical cost variation by geographic area. These and other factors could result in higher or lower Cadillac tax burdens, even though they are not related to plan design.

### What kinds of coverage are taxed?

For the Cadillac tax, applicable employer-sponsored coverage includes not only group health premiums paid to health insurers, but also premium-equivalent amounts under self-insured arrangements. Furthermore, employer contributions to health savings accounts (HSAs), medical savings accounts (MSAs), and health flexible spending accounts (FSAs)—as well as notional amounts attributed to employees in health reimbursement arrangements (HRAs)—are counted as coverage when calculating this tax. Stand-alone dental and vision coverage are excluded from the tax.

Depending on the type of coverage, the employer, plan sponsor, or plan administrator may be the party responsible for remitting the tax.

## Looking ahead

With the tax threshold indexed to the CPI-U, whether and to what extent a given employer's health coverage becomes subject to the Cadillac tax depends on the pace of medical inflation compared with general inflation. For some context, the annualized change in the CPI-U from April 2004 to April 2014 was approximately 2.3%.

Over a similar period, the annualized change in the Milliman Medical Index™ (MMI™), which tracks the total cost of health benefits for a typical family of four enrolled in a preferred provider organization (PPO) plan, exceeded the CPI-U by 5.3% per year. With medical claims cost trend historically outpacing inflation, more plans over time will increasingly be affected by the tax, and the tax burden similarly may represent an increasing share of an employer's healthcare costs.

As a very simple hypothetical example, take a single teacher whose 2010 group healthcare coverage had a total annual cost of \$6,000, and suppose that premiums increase at a trend of 6%. Further, assume that the annual change in the CPI-U is 2.3%.

Figure 1, below, shows a projection of the annual premium (or premium equivalent) relative to the tax threshold. Of course, the tax would be based on the costs for all members in this plan and would depend on additional factors (e.g., demographics of the group, FEHBP Standard Plan cost increases from 2010 to 2018, and the nature of the work of the rest of the employees at this hypothetical company). The example simply illustrates how the relatively quicker pace of medical inflation causes the tax to apply to this plan starting in 2022 and to begin to represent a progressively larger fraction of the cost of the coverage over time.

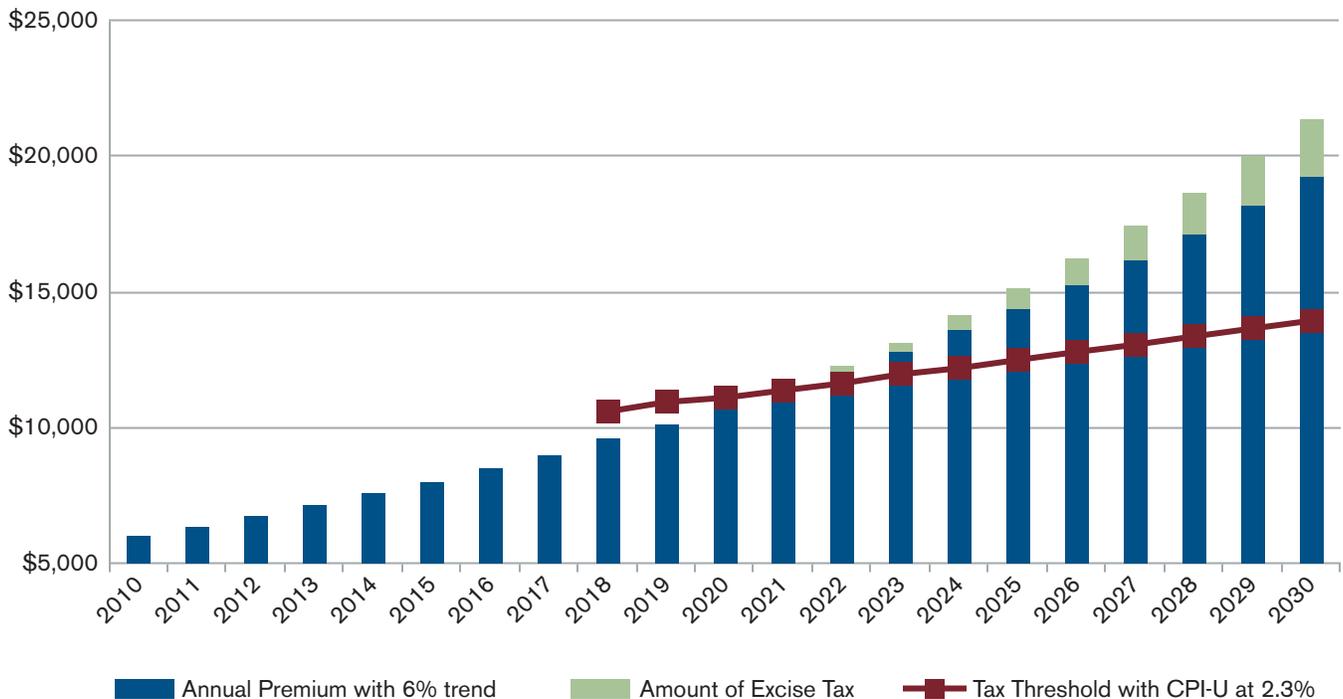
## Implementation and leveraging

While the IRS has only recently requested comments in advance of rulemaking for the implementation of the Cadillac tax, employers have already begun to feel the effects. The Financial Accounting Standards Board (FASB) and the Governmental Accounting Standards Board (GASB) have rules requiring employers to value, and report liabilities for, the cost of future benefits that are offered to retirees. The ACA's effects must be reflected in these accounting standards, and the Cadillac tax drives up the future cost of employer-provided healthcare coverage.

The taxable status of the insurer or administrator that the employer selects could cause the 40% excise tax to be subject to corporate income tax, leveraging the financial impact such that every \$1.00 of provided healthcare benefit beyond the threshold may cost an employer \$1.61, or more.

As the Department of Health and Human Services and the IRS issue rules and other guidance in the next couple of years, employers should expect, absent intervention by Congress, their other postemployment benefit (OPEB) costs and liabilities to rise. To date, calculations of future costs have often been simplified as a result of the many unknown details of the pending regulations. As many employers and their advisors begin considering the details, their future cost projections could rise sharply. Employers will find that assessing the impact and implementing a strategy to manage these costs prior to the application of the Cadillac tax are critical financial exercises.

FIGURE 1: HYPOTHETICAL CADILLAC TAX % ATTRIBUTED TO ONE EMPLOYEE



## Implications for employers

Unless the trends of the past decades do not continue into the future, employers could face healthcare cost increases that are actually higher than historical trends. Rapidly climbing healthcare costs, which the Cadillac tax will amplify over time, will create difficult choices for many employers. Faced with the choice of paying the cost of a tax of 40% to more than 60% of the cost of coverage exceeding the threshold, employers may need to reevaluate the value proposition of providing healthcare benefits for their active (and retired) employees. Depending upon the employer's particular circumstances, employers may offer less comprehensive benefits or eventually drop healthcare coverage.

The various employer mandates and penalties associated with the ACA have already caused many employers to evaluate the feasibility of their current employee benefit approaches. Recently, major retailers reportedly have ceased offering health insurance benefits for employees working under 30 hours per week. Some employers have elected to discontinue offering health insurance altogether, instead offering employees cash compensation to buy coverage on the public exchanges, in spite of the penalties associated with doing so. The Cadillac tax, and the intricacies of its calculation, will increase the need for employers to make similar types of decisions in the future.

Regardless of whether an employer or insurer chooses to bear the entire cost of the tax, reduce benefits, pass all or a portion of the tax on to employees by reducing the portion of premiums that the employer subsidizes, or reduce employer contributions to any applicable side accounts such as a health FSA, the final cost will ultimately be borne by employees.

In all likelihood, employers will combine several approaches to alleviate some of the tax burden. Of course, such plan design changes could prove difficult to make in practice, as employers may be faced with pressure from active employees, nearly or currently retired employees, and unions.

## Conclusion

As the first year of the Cadillac tax in 2018 approaches, there will be increased attention given to the tax and its implications. While this article presented a very simplified example, the calculations involved in projecting the future burden of this tax are complex and will become a necessary part of human resources (and corporate finance) benefit planning, union negotiations, and OPEB valuations. Some of the factors impacting employers' tax burdens will not be related to their chosen plan designs or the actual people receiving the benefits, adding yet another layer of complexity for HR and senior managers. For employers, this new tax will compound the current challenges associated with rising healthcare costs and will necessitate a strong forward-looking strategy along with very difficult benefit decisions.



Rob Pipich, FSA, MAAA, is a consulting actuary in the Philadelphia office of Milliman. Contact him at [rob.pipich@milliman.com](mailto:rob.pipich@milliman.com).



Chris Ruff, FSA, MAAA, is an actuary in the Philadelphia office of Milliman. Contact him at [chris.ruff@milliman.com](mailto:chris.ruff@milliman.com).

This article was peer reviewed by Stuart D. Rachlin, FSA, MAAA, a consulting actuary in Milliman's Tampa office.

**Benefits Perspectives** is published by Milliman's Employee Benefits Editorial Committee as a service to our clients. This electronic newsletter is available at [www.milliman.com](http://www.milliman.com). Articles or excerpts from this publication may be reproduced with permission when proper credit is attributed to the firm and the author.

### Editor-in-Chief

Marjorie N. Taylor

### Committee

Eddy Akwenuke  
Richard Bottelli  
Jeffrey Budin

Charles Clark  
Jeffrey R. Kamenir  
Martha Moeller

Troy Pritchett  
Katherine A. Warren

Because the articles and commentary prepared by the professionals of our firm are often general in nature, we recommend that our readers seek the counsel of their attorney and actuary before taking action. The opinions expressed are those of the authors.

Inquiries may be directed to:

### Editor

1301 Fifth Avenue, Suite 3800  
Seattle, WA 98101-2605  
Tel: +1 206 624.7940  
[perspectives.editor@milliman.com](mailto:perspectives.editor@milliman.com)