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BENEFITS BRIEF

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# Treasury/IRS Take First Step In Implementing 40% High-Cost "Cadillac" Excise Tax with Notice 2015-16

Treasury and the Internal Revenue Service have issued initial guidance on one of the least popular provisions of the Affordable Care Act--the excise tax on high cost employer-sponsored health coverage (commonly referred to as the "Cadillac Tax") ("40% Excise Tax" or "Tax"). Although attempts on Capitol Hill to repeal or delay the 40% Excise Tax are likely to continue, whether any of these efforts succeed remains to be seen. Meanwhile, in Notice 2015-16 ("Notice"), Treasury and the IRS offer the first glimpse of the complex requirements that employers, insurers and third party plan administrators will face if the 40% Excise Tax goes into effect in 2018, as called for by the statute.

Although the Notice does not offer guidance on which taxpayers may rely, it does offer insight into how Treasury/IRS are thinking about the 40% Excise Tax and represents a not-to-be-missed opportunity for stakeholders to provide comments that could help shape the final rules. This is especially true with respect to the definition of coverage to which the 40% Excise Tax applies and the determination of costs for purposes of calculating potential 40% Excise Tax liability. For example, it appears that Treasury/IRS are willing to exempt certain on-site medical clinics that provide de minimis care and both insured and self-funded vision and dental plans and employee assistance programs that meet the excepted benefit requirements. However, it also appears that employer contributions to health savings accounts, including pre-tax cafeteria plan contributions made by employees, will count toward the calculation, as well as contributions to health reimbursement arrangements and the cost of executive physical programs. The Notice also illustrates that several fundamental concepts relating to premium calculations under the COBRA continuation of coverage rules, upon which the calculation of the 40% Excise Tax is based, need to be resolved.

**<u>What Actions You Should Take</u>**

Treasury/IRS specifically invite comments on all of the issues addressed in the Notice and any other issues arising under the 40% Excise Tax, which must be submitted no later than May 15, 2015. Now is the time for insurers, employers, and plan sponsors and administrators to share their comments, concerns, and insights with Treasury/IRS in order to maximize the chance that final rules fully take their comments into consideration.

It appears that Treasury/IRS are using the same approach to rulemaking with respect to the 40% Excise Tax that they used with the employer shared responsibility provision. First, Treasury/IRS have indicated that several notices will be issued. The first notice, which is the subject of this alert, solicits comments on the types of coverage that should be subject to the 40% Excise Tax and how to determine the cost of coverage and apply the statutory dollar limits when calculating the Tax. A planned second notice will include procedural issues related to the calculation and assessment of the Tax. After considering comments on both notices, Treasury/IRS will publish proposed regulations with a formal notice and comment period. Finally, after considering the comments on the proposed regulations, Treasury/IRS will publish final regulations, presumably in advance of the effective date of taxable years beginning on or after December 31, 2017.

On the positive side, the projected schedule means that taxpayers will have several opportunities to weigh in on the rules that will eventually apply to the 40% Excise Tax. But a protracted timeline also may mean that Treasury/IRS believe they will need to develop complex rules for implementation and administration of the Tax. This could mean that by the time final rules are published, employers, insurers, plan administrators and others impacted by the Tax may have very little time in which to implement necessary administrative processes to meet reporting obligations and little ability to plan for the economic impact of the Tax on their businesses. Affected parties may want to begin planning now based on the Notice, since it gives the first clear indication of the views of Treasury/IRS on a number of significant issues.

**Background- Code section 4980I**

The Affordable Care Act added section 4980I to the Internal Revenue Code. Section 4980I imposes an excise tax on certain high cost employer-sponsored health coverage. Generally, under Section 4980I, if the aggregate cost of applicable coverage provided to an employee exceeds a statutory dollar limit, the excess amount is subject to a 40% excise tax.

Section 4980I provides that the cost of applicable coverage is to be determined under rules similar to those used for determining the cost of COBRA coverage. As with determinations made under the individual and employer shared responsibility provisions, the cost of coverage is looked at on a monthly, and not an annual, basis. Applicable coverage is generally coverage under a group health plan offered by an employer that is excludable from an employee's gross income (or would be excludable if it were employer-provided coverage, so also including coverage paid for by an employee with after-tax dollars). The 40% Excise Tax applies to applicable coverage provided to former employees (including retirees), surviving spouses, and other primary insureds, as well as coverage provided to employees.

The statutory dollar limits for 2018 are $10,200 for self-only coverage and $27,500 for other-than-self-only coverage (these amounts will be increased in 2018 if the actual growth in the cost of the Blue Cross/Blue Shield standard benefit option under the Federal Employees Health Benefits Plan between plan year 2010 and plan year 2018 exceeds 55%). Beginning in 2019, the dollar limits will be subject to annual cost-of-living adjustments. For 2018 and later, the dollar limits are also increased in certain circumstances, including for age and gender, for participants in a plan in which the majority of employees covered are either engaged in a high risk profession (specifically listed in the statute) or employed to repair or install electrical and telecommunications lines, and for certain qualified retirees.

Liability for the 40% Excise Tax is allocated based on the type of applicable coverage offered. Health insurance issuers pay if the Tax is assessed against an insured plan, employers pay if the Tax is assessed against coverage consisting of employer contributions to an HSA or an Archer MSA. And "the person that administers the plan" pays the Tax if it is assessed against any other type of coverage. It is always the employer's obligation to calculate the amount of the Tax and notify the liable entity.

Taxes paid under the provision are not deductible for federal tax purposes.

The Tax is effective for taxable years beginning after December 31, 2017.

**An In-Depth Look at Notice 2015-16**

The crux of the Notice is the description of potential approaches to the following three issues: (1) the definition of applicable coverage; (2) determination of the cost of applicable coverage; and (3) application of the annual statutory dollar limits to the cost of applicable coverage. Below, we discuss each of these issues, highlighting both the good news and the bad news.

Definition of Applicable Coverage

Applicable coverage generally means coverage under a group health plan offered by an employer that is excludable from an employee's gross income (or would be excludable if it were employer-provided coverage, so also including coverage paid for by an employee with after-tax dollars). The following types of coverage are mentioned by the *statute* as being applicable coverage: Health FSAs, HSAs, Archer MSAs, governmental plans, on-site medical clinics, retiree coverage, multiemployer plans, and coverage for a specified disease or illness if the coverage is excludable or deductible from gross income.

Although not listed in the statute, Treasury/IRS indicate that executive physical programs and HRAs are expected to be included as applicable coverage under future guidance. Treasury/IRS argue that these types of coverage generally meet the definition of applicable coverage and are not specifically excluded by the statutory language.
The following types of coverage are explicitly excluded from the statutory definition of applicable coverage and will be so excluded in future guidance: accident or disability income insurance, supplemental insurance, liability insurance, workers' compensation, automobile medical payment insurance, credit-only insurance, long term care insurance, dental and vision insurance, and fixed indemnity insurance that is not excludable or deductible from gross income.

*Future Guidance on the Definition of Applicable Coverage*

The Notice anticipates future guidance on a number of issues relating to the definition of applicable coverage:

*The (Relatively) Good News*

- Coverage provided to members of the military and their families by State or Federal governments is expected to be excluded from the definition of applicable coverage.

- The definition of applicable coverage is expected to exclude on-site medical clinics that offer only de minimis medical care to employees. Treasury/IRS request comments on what rules should apply to on-site medical clinics that provide immunizations, allergy injections, nonprescription pain relievers, and treat injuries caused by accidents at work. They are also interested in suggestions for how to determine the cost of coverage provided by such clinics to the extent that it is applicable coverage.

- Treasury/IRS are considering whether to exercise their regulatory authority to exclude self-insured limited scope dental and vision coverage, as well as employee assistance programs that qualify as excepted benefits under the recently amended excepted benefit regulations.

*The Bad News*

- Employer contributions to HSAs and Archer MSAs, including pre-tax salary reductions, are expected to be applicable coverage while employee after-tax contributions are not. Such a rule promises to create administrative complexity for all involved.

Determination of Cost of Applicable Coverage

The 40% Excise Tax is imposed on the excess of the aggregate cost of applicable coverage over the applicable dollar limit described above. Thus, prior to calculating potential liability, a taxpayer must first know the aggregate cost of all provided coverage.

*The (Relatively) Good News*

Treasury/IRS seem open to hearing from taxpayers about how to determine the cost of coverage.

- Self-Insured Plans: Self-insured plans may currently choose between two methods for determining the COBRA applicable premium: the actuarial basis method and the past cost method. Treasury/IRS anticipate generally applying these two methods for purposes of the 40% Excise Tax. They also seek comments on those methods, specifically about whether and how to permit an employer to switch between methods.

- Determination Period: COBRA applicable premiums are determined in advance for a 12-month period. Treasury/IRS seek comments on whether the same rules should apply for purposes of the 40% Excise Tax, whether additional guidance would be helpful, and on the feasibility of using actual costs incurred during the determination period to calculate applicable premiums for self-insured plans.

*The Bad News*

The statute says that costs need to be calculated "under rules similar" to the rules for calculating COBRA premiums. A number of issues arise in computing COBRA premiums, however, for which specific guidance has not been issued. The Notice devotes the highest page count to this issue and even in such a preliminary form, the future rules appear alarmingly complicated.

*Future Guidance on Determination of Cost of Applicable Coverage*

The Notice mentions and requests comments on the following approaches to determining the cost of coverage:

- Similarly situated individuals. Treasury/IRS anticipate that the cost of any specific coverage for an employee will be based on the average cost of that type of applicable coverage for that employee and all similarly situated employees. Each group of similarly situated employees would be determined by starting with all employees covered by a particular benefit package (*e.g.*, an HMO and a PPO or two PPOs and a high-deductible health plan) provided by the employer, then subdividing that group based on mandatory disaggregation rules, and allowing further subdivision of the group based on permissive disaggregation rules (as explained below).

    - Aggregation by benefits package. The initial groups of similarly situated employees would be determined by aggregating all employees covered by a particular benefit package provided by an employer. The employees enrolled in each different benefit package would be grouped separately.

- Mandatory disaggregation (self-only coverage and other-than-self-only). After aggregating all employees covered by a particular benefit package, the employer would be required to disaggregate the employees within the group covered by the benefit package based on whether an employee had enrolled in self-only coverage or other-than-self-only coverage.

- Permissive aggregation within other-than-self-only coverage. Employers would not be required to determine the cost of applicable coverage for employees receiving other-than-self-only coverage based on the number of individuals covered in addition to the employee.

- Permissive disaggregation. Treasury/IRS are considering allowing, but not requiring, an employer to further subdivide the group of employees that would be treated as similarly situated. Specifically, they are considering whether disaggregation should be permitted based on a broad standard such as bona fide employment-related criteria, or a more specific standard, such as a specified list of limited specific categories for which permissive disaggregation would be allowed.

While the approaches are described for purposes of the 40% Excise Tax only, Treasury/IRS are considering whether the approaches should also apply when determining COBRA premiums. The Notice does not request comments regarding COBRA calculations, but to the extent taxpayers feel it would be helpful to have the same rules apply for both COBRA and the 40% Excise Tax, stakeholders should consider addressing this as part of any written comments to Treasury/IRS.

- HRAs

Treasury/IRS anticipate that an HRA will be applicable coverage for purposes of the 40% Excise Tax. They are considering several approaches to how to determine the cost of an HRA, balancing the sometimes competing goals of providing employers with certainty while at the same time both getting the valuation right and minimizing administrative complexity.

Determining the Applicable Dollar Limit

As noted above, the statute contains different dollar limits based on whether an employee has self-only or non-self-only coverage. The Notice describes several potential approaches for applying the dollar limit to employees who have both self-only and other-than-self-only coverage (for example, an employee with self-only major medical coverage but an HRA that covers the employee as well as his or her family). None of the described approaches falls squarely into a (relatively) good or bad news column, perhaps because the Notice does not include a high level of detail, but rather appears to be primarily a request for comments.

Under one approach, the applicable dollar limit would depend on whether the primary coverage is self-only or other-than-self-only. An alternative approach would apply a composite dollar limit based on the cost of each type of coverage. Comments on the approaches are invited, as are suggestions for other possible methods for determining the dollar limit in situations when individuals have both types of coverage.

The Notice also requests comments on approaches for calculating and applying the upwards adjustments for qualified retirees, high risk professions, and the age and gender characteristics of an employer's workforce.

Finally, Treasury/IRS invite comments on alternative approaches for determining the cost of applicable coverage. Treasury/IRS note that stakeholders have asked whether the cost of applicable coverage could be determined by reference to coverage available elsewhere based on, for example, actuarial values. The Notice indicates some concern that such metrics might be based only on essential health benefits and thus may not fully account for other features and benefits and that two plans that have different costs of applicable coverage might nonetheless have equal actuarial values. Despite these concerns, however, the Notice invites comments on whether any alternative approaches for determining the cost of applicable coverage, presumably including the use of actuarial value based standards, would be both useful to taxpayers and consistent with the statutory requirements of the provision.

**Special Issues for Unions to Consider**

The news is mixed for multiemployer plans in particular. The Notice points out that on the one hand multiemployer plans are, by statutory definition, applicable coverage, although on the positive side coverage under a multiemployer plan is always treated as other-than-self-only coverage for purposes of the tax. Treasury/IRS propose to carry that definition through to any of their potential alternate approaches to applying dollar limits.

**Conclusion**

Notice 2015-16 represents the first step in the IRS/Treasury rulemaking process with respect to the 40% Excise Tax. Although we are expecting a second notice later this spring as well as a follow-on proposed rule, interested parties should review the Notice very carefully as it is a good indicator of how the regulators are interpreting the governing statutory language. The Notice is also very helpful for employers and insurers who are beginning (or continuing) to consider how the 40% Excise Tax may apply to their plans or policies. Interested parties should certainly consider submitting written comments on the Notice to IRS/Treasury. Comments are due by May 15, 2015. Please contact any of the attorneys in the Health and Welfare Practice Group at Groom Law Group or your regular Groom Law Group attorney for information about participating in a group comment letter.