



COMPLIANCE SERVICES **ALERT** LOCKTON BENEFIT GROUP



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IRS Again Solicits Input on Cadillac Tax: Procedural and Payment Issues

On Thursday, July 30, the Department of Treasury and the Internal Revenue Service (IRS) issued their second request for information (RFI) related to the excise tax on high-cost employer coverage that will apply in 2018. Earlier this year, the Treasury issued an initial RFI to solicit comments from employers on the tax. (For more information on this initial RFI, please see our previous [Alert](#).)

Health coverage under insured and self-funded employer plans will be subject to a nondeductible 40 percent excise tax, known as the Cadillac tax, to the extent the value of health coverage provided to an employee exceeds prescribed thresholds (generally, \$10,200 for single coverage and \$27,500 for any other level of coverage).

The latest RFI discusses liability for payment of the tax, allocation of the tax among coverage providers and payment of the tax.

Overview

The Cadillac tax is intended to slow growth of health costs and be a revenue generator that helps offset the \$1 trillion cost of the Affordable Care Act (ACA). The calculation of coverage values includes the value of major medical coverage, health reimbursement arrangements (HRAs), nontaxable health savings account (HSA) contributions and health flexible spending account benefits (whether provided by an employer or the employee), as well as on-site clinics.

For purposes of calculating the value of coverage, the law prescribes a methodology similar to how COBRA rates are determined. Employers are permitted to adjust the \$10,200 and \$27,500 thresholds upwards based on the age and gender of their workforce.

Although the employer determines the tax on a *calendar* year basis, the tax is accrued on a monthly basis and paid annually.

Mind-Bending Tax Administration Issues

The IRS's collection of the Cadillac tax presents some complex administrative issues due to a variety of factors:

- Payments of the Cadillac tax are not tax deductible (because it is an excise tax).
- To determine whether the tax applies, the employer will look to each covered employee and determine the total cost of coverage, including major medical coverage, HSA contributions, HRA allocations, etc. supplied to that individual employee. If the aggregate coverage values for that employee trigger the tax, the employer must notify each coverage provider of the proportionate amount of tax owed by that provider. Then, the provider will remit payment to the IRS (and will likely charge that cost back to the employer).

Lockton comment: Regarding who runs the calculation, there are special rules for union affiliated ("multiemployer") plans and employers that are members of a controlled group of corporations, trades or businesses.

To illustrate the issues, let's look at an example:

Alan is a full-time employee of ABC Company. In 2018, Alan elects single major medical coverage and a health FSA benefit of \$2,000. The value of the major medical coverage alone is \$10,000, but ABC also provides a separate, self-insured HRA benefit of \$700. The major medical plan is insured by MegaHealth Insurance Company (Mega). ABC uses a third-party administrator (TPA) to administer the health FSA, and ABC self-administers the HRA.

Step One – Does the Cadillac Tax apply?

The total value of Alan's coverage is \$12,700, which exceeds the Cadillac tax threshold by \$2,500 ($\$12,700 - \$10,200 = \$2,500$). Let's assume ABC is not permitted to adjust those thresholds based on age and gender demographics of its workforce. The amount of Cadillac tax owed, with respect to Alan, will be \$1,000 ($\$2,500 \times 40\%$).

Step Two – Allocating the Tax

The law requires the \$1,000 tax be proportionately allocated between the "coverage providers" of Alan's benefits – in this case the insured major medical plan, the FSA and the HRA. As noted earlier, the responsibility for calculating this, on an employee-by-employee basis, falls on the employer. If we do the math, the allocation of the \$1,000 tax looks like this:

Insured medical = \$787

FSA = \$157

HRA = \$55

The law also requires the coverage provider to remit the tax to the IRS. We know that Mega is the coverage provider for the insured major medical plan, and ABC would qualify

as such for the HRA. Is the TPA the coverage provider for the FSA or is it ABC? We'll get to that in a moment.

One bit of good news – the Cadillac tax payable is not itself included in determining the cost of coverage. In other words, the value of the major medical coverage remains at \$10,000. It does not increase to \$10,787.

Before we get deeper into the weeds about how the IRS gets its \$1,000, we offer a few practical observations:

- Neither Mega nor the TPA is going to realize it owes the Cadillac tax. Mega's coverage is \$10,000, which is below the \$10,200 threshold, but it will be required to remit the tax because the *total* value of Alan's *total* coverage exceeds the threshold. ABC must notify Mega that it owes \$787, so Mega can pay the IRS. (We'll discuss the TPA in a few moments).
- Mega is unlikely to pay the \$787 to the IRS without being reimbursed by ABC Company. Mega will want to build its tax payment into the amount it charges ABC Company. The problem is that the additional \$787 will be taxable income to Mega that will *not* be offset by a \$787 deduction when it pays the tax (remember: it's a nondeductible excise tax). Mega will need to collect more than \$787 from ABC to offset its costs. This additional amount will depend on Mega's marginal tax rate. Let's assume for our example that Mega pays an effective state and federal income tax rate of 27 percent. That means the starting point for determining this "income tax reimbursement" is \$213, so in addition to its premium cost, ABC will pay Mega at least an additional \$1,000 on account of the Cadillac tax ($\$787 + \$213 = \$1,000$).

Lockton comment: In fact, Mega may want more than \$1,000 from ABC. That's because Mega needs to pay income tax not only on ABC's reimbursement of Mega's Cadillac tax payment, but also on the cash Mega uses to pay the tax in the first place. In other words, to pay a \$787 non-deductible excise tax, Mega needs \$1,000 in taxable cash, assuming that same 27 percent effective state and federal corporate tax rate. Then it may want ABC to reimburse it for the \$270 income tax liability it'll owe on the \$1,000 reimbursement. And Mega will likely tack on an administrative fee, for a grand reimbursement totaling something north of \$1,270 on a Cadillac tax payment of \$787. In other words, the total "income tax reimbursement" will be at least \$483 ($\$213 + \270).

Do you have a headache yet? I bet the IRS does, as it tries to solicit comments on the best way to structure and pay the tax.

Entities Liable for the Tax

As discussed above, the coverage provider owes the tax. For insured coverage, the coverage provider is the insurer. For HSAs, the employer is the coverage provider. In all other instances, the coverage provider is the "person who administers the coverage." Does that mean the TPA above owes the \$157 to the IRS? Or should ABC, the plan sponsor, be liable?

The law itself offers no solution to this riddle. The IRS is asking for comments on two alternative approaches:

- The TPA that performs “administrative functions” (to be defined) would be the coverage provider.
- The entity that has ultimate responsibility for the plan, as stated in the plan document, would qualify as coverage provider. Typically, this would be the employer/sponsor (that’s ABC in our example above). From the self-insured employer’s standpoint, it would be better if it were considered the coverage provider. Otherwise it’ll have to reimburse the TPA not just for the nondeductible payment of the tax, but also for the gross-up to account for the TPA’s payment of income tax on the amount it recouped just to make itself whole. For that matter, it might be nice if the IRS allowed even the *insured* employer to pay the Cadillac tax on behalf of the insurer, to avoid having to gross the insurer up for the income tax liability on any reimbursement paid by the employer.

Determination of Cost

The IRS acknowledges there will be timing issues in determining plan cost for purposes of the excise tax. Self-funded and experience-rated insured plans have run-out periods that allow claims to be submitted after the end of the plan year. Experience-rated insured plans may provide premium discounts based on favorable claims experience. Each of these items has the potential to affect the calculation of the plan’s cost. The IRS is soliciting feedback on these issues, as well as how these payments and discounts affect COBRA rates.

Tax on the Tax

Recall that in our example, Mega will need to collect more than \$787 in order to break even when it pays the tax. Any amount that Mega receives from ABC is taxable to Mega, so Mega will need to increase the amount of the reimbursement it demands of ABC to account for the income tax Mega will pay on that reimbursement (the “income tax reimbursement”). Of course, the TPA has a similar issue if it has to pay the \$157 tax for the FSA.

What if Mega rolls the amount of the tax it paid, and any additional reimbursement it demands of ABC, into ABC’s premium rate? Doing so would increase the cost of the coverage supplied by Mega, further exacerbating ABC’s Cadillac tax problem. To remedy this, the IRS is suggesting that it might not require an income tax reimbursement (\$483 in our example above) be included in the cost of Mega’s coverage when ABC runs its Cadillac tax calculation. The IRS is considering whether the income tax reimbursement must be separately identified and billed, in order to be excluded from the calculation. The IRS has asked for comments on practical issues associated with these approaches, such as how best to take into account variability of tax rates that will apply to the coverage providers or whether a standard marginal tax rate should apply.

Other Items in the Notice

In addition to the byzantine tax administration issues, the IRS asks for comments on a variety of other topics concerning the tax. These items are discussed below.

- **Account-Based Plans (FSAs, HRAs, HSAs):** Recall that the Cadillac tax accrues on a monthly basis, based on aggregate coverage costs for the employee for the given month. For account-based plans, such as health FSAs, HRAs and HSAs, contributions to the account would be ratably allocated over the months in the plan year, regardless of the timing of actual contributions. For example, for an HRA with a \$1,200 annual maximum, \$100 would be allocated to each calendar month, regardless of how much is actually contributed or reimbursed in a given month. Other special rules would apply to FSA programs that include employer flex credits and FSA programs that allow carryovers of up to \$500. The latter rules would ignore any carryover amounts when determining the value of the FSA.
- **Discriminatory Self-Funded Plans (Tax Code section 105(h)):** Any taxable reimbursements to highly compensated individuals are ignored when determining the value of the self-funded coverage. Previous guidance seemed to indicate that taxable reimbursements reduced the cost of coverage for Cadillac tax purposes.
- **Age and Gender Adjustments to Tax:** One of the upward adjustments in the Cadillac tax is applied based on the age and gender characteristics of the employer's employees. The IRS is asking for comments on how to determine an employer's age and gender distribution compared to the general population, and how best for the IRS to develop actuarial tables to calculate the adjustment.
- **Payment of the Tax:** The IRS will use Form 720 to collect the tax. This is the same form used by employers to pay the annual PCORI fee. (For more information on IRS Form 720, please see our previous [Alert](#).)

What's Next?

The IRS will accept comments through Oct. 1, 2015. The IRS's next step will be to issue proposed regulations later this year or in early 2016. The agency has indicated it hopes to issue final regulations well in advance of 2018.

In the meantime, a growing coalition is supporting a bill to repeal the Cadillac tax. Lockton is cautiously optimistic that may actually happen, but not in 2015. If the tax were repealed, employers would be spared the financial and administrative agony associated with it

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