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Cadillac Tax Preliminary Guidance: Part II

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The IRS issued Notice 2015-16 to begin the process of developing regulatory guidance regarding the excise tax on high cost employer-sponsored health coverage, commonly known as the “Cadillac Tax.” Beginning January 1, 2018, a 40% excise tax will apply on the cost of applicable coverage that exceeds prescribed thresholds (described later in this article).

Our previous article (Part I, dated April 16, 2015) addressed the definition of applicable coverage. Part II looks at how the applicable statutory limit may apply with respect to the cost of coverage and methods to determine the cost of applicable coverage.

The IRS seeks comments on these proposed approaches.

Dollar Limit Adjustments

The statute provides two baseline per-employee dollar limits for 2018:

- $10,200 for self-only coverage, and
- $27,500 for coverage other than self-only.

The guidance clarifies that these amounts are subject to certain adjustments, as follows:

- **Health cost adjustment percentage** (applicable in 2018 only). This adjustment will be applied to the per-employee dollar limit for 2018 to determine the actual dollar limits for that year.

- **Cost of living adjustment** (applicable after 2018). For taxable years after 2018, a cost-of-living adjustment based on CPI-U plus one percent will be applied to determine applicable dollar limits.

- **Qualified retirees[1] and high-risk professions[2].** An additional amount is added to the dollar limits for qualified retirees and individuals who participate in a plan sponsored by an employer the majority of whose employees covered by the plan are engaged in high-risk professions or who repair or install electrical or telecommunication lines. The additional amounts added to the prescribed thresholds are $1,650 for self-only coverage and $3,450 for coverage other than self-only.

- **Age and gender adjustment.** For 2018 and beyond, the dollar limits for an employer may be increased by an age and gender adjustment if the age and gender characteristics of an employer's workforce are different from those of the national workforce. The amount of this adjustment is to be determined.

- **Multiemployer plans.** Coverage provided under a multiemployer plan is treated as coverage other than self-only (e.g., the $27,500 threshold applies to both self-only coverage and coverage other than self-only).

Determination of the Cost of Applicable Coverage

This new excise tax will apply on the excess, if any, of the aggregate cost of applicable coverage of an employee for a month over the applicable dollar limit.

Under the existing framework, rules similar to the COBRA rules for determining applicable premium will be used to determine the cost of applicable coverage. Given that the regulators have provided limited guidance on determining the cost of COBRA coverage, in particular for self-insured plans and HRAs, guidance issued under section 4980I is likely to affect existing COBRA rules (section 4980B).

Currently, the COBRA applicable premium must be determined for a 12-month determination period, and must be determined before the start of such period. For self-insured plans there are two methods to determine the COBRA applicable premium:

- the actuarial basis method, and

- the past cost method.

Absent guidance employers and plans must operate in good faith compliance with a reasonable interpretation of the section 4980B statutory requirements.

Briefly, the Notice outlines potential approaches to determining the cost of applicable coverage:

- **Similarly situated individuals.** The IRS proposes determining similarly situated individuals through mandatory aggregation, aggregating individuals by elected benefit package (e.g., PPO, HMO, or HDHP). Then, individuals will be disaggregated by

those who have self-only coverage and those with other than self-only coverage. This is referred to as mandatory disaggregation.

- In addition, the IRS is considering whether to allow permissive disaggregation, meaning separate determination of costs of coverage within family coverage based on the number of covered individuals. Another type of permissive disaggregation under consideration is disaggregation based on an employee's similarly situated status such as bona fide employment-related criteria (current employee versus former employee status, compensation, bona fide geographic distinctions, etc.).

- The IRS has requested comments on these various aggregation methodologies.

- **Self-insured plans.** The IRS is looking to provide guidance that will likely affect not only how the cost of applicable coverage is determined for purposes of the excise tax, but how self-insured plans determine the COBRA applicable premium as well. Notably:

  - With limited exception, the method chosen (actuarial or past cost) would need to be used for at least 5 years (exception for the past-cost method due to significant plan changes).

  - Under the actuarial method, a reasonable estimate of the cost of providing coverage under the group health plan would be based on the actual cost the plan is expected to incur and not minimum or maximum exposure.

  - The IRS asks for comments on whether an accreditation of individuals making these actuarial estimates should be required and whether it would be preferable to provide a specific list of factors that must be satisfied to make this actuarial determination.

  - For the past-cost method, the IRS proposes specific cost factors that would be taken into account to determine cost and how those factors can be applied.

- **HRAs.** The IRS has issued very limited guidance on determining the COBRA premium for HRAs. Briefly, the IRS has stated that the COBRA applicable premium for an HRA may not be based on a qualified beneficiary's reimbursement amounts available from the HRA. The IRS proposes a number of mechanisms for determining COBRA costs for HRAs and requests comments on these approaches.

- **Determination period.** The IRS also seeks comments as to how the determination period should be set for COBRA and whether that same

1 Although the use of model notices is not required, the DOL will consider use of the model notices, appropriately completed, to constitute compliance with COBRA's notice content requirements.
2 http://www.gpo.gov/fdsys/pkg/FR-2014-05-07/pdf/2014-10416.pdf
3 Health plans should send annual notice to employees in states that provide Medicaid or SCHIP premium assistance.
4 For the most part, this will be gauged on a calendar-year basis because out-of-pocket limits run on a calendar-year basis.
5 This is also referred to as an annual limitation on cost-sharing.
6 Reference-based pricing means the plan pays a fixed amount for a particular procedure (for example, a knee replacement), which certain providers will accept as payment in full.

determination period can be used to determine the cost of applicable coverage. Under existing COBRA rules, the method for calculating the applicable premium must be elected prior to the determination period for which the applicable premium applies.

Conclusion

Determining the cost of applicable coverage raises a number of issues that affect the Cadillac Tax, COBRA continuation of coverage, and other areas of benefits law (e.g., W-2 health coverage reporting). This Notice provides early indications of how the IRS contemplates addressing these issues. Future guidance will have a broad impact on employer sponsored group health plan compliance and plan designs. We will be monitoring future regulatory developments, along with legislative changes that may impact the 2018 excise tax. This is the start of a long regulatory process and additional guidance and opportunity for comments will be forthcoming.

For a copy of the Notice and information on how to submit comments, visit: http://www.irs.gov/pub/irs-drop/n-15-16.pdf.

[1]A qualified retiree means an individual who is receiving coverage by reason of being a retiree, has achieved the age of 55, and is not entitled to benefits or eligible for enrollment in Medicare.

[2]High risk professions include:

- *Law enforcement officers*
- *Employees in fire protection activities*
- *Individuals who provide out-of-hospital emergency medical care (emergency medical technicians, paramedics and first responders)*
- *Longshore workers*
- *Construction, mining, agriculture (but not food processing, forestry and fishing industries; and*
- *Employees retires from one or more of the listed high risk professions who was engaged in that high risk profession for at least 20 years.*