HEALTH CARE REFORM NEWS

...From the Employer Perspective

March 10, 2015

Initial IRS Guidance on 2018 High Cost Plan Excise Tax

The Internal Revenue Service (IRS) recently released **Notice 2015 – 16**, which is its first step toward regulations on the High Cost Plan Excise Tax ("Cadillac tax") section of the Affordable Care Act (ACA). The tax goes into effect as of January 1, 2018, and employers have been anxious for direction on many complex provisions as they modify their plans to get below the excise tax limits. They will be disappointed that the Notice gives few specific answers, but it does give strong indications of what's likely to come in future regulations.

Similar to other previous high visibility parts of ACA, the IRS is issuing this Notice to share its preliminary thinking about key Cadillac tax provisions and ask for marketplace comments by May 15, 2015. As stated in the first sentence: "*This notice is intended to initiate and inform the process of developing regulatory guidance regarding the excise tax on high cost employer-sponsored health coverage……."* The IRS intends to issue an additional notice and seek comments on other specific topics, with these two notices and related comments being the foundation for proposed and then final regulations. However, no timing is provided for any of these next steps.

BACKGROUND

ACA added IRC Section 4980I to impose a 40% tax on the "excess benefit amount" of "applicable employer-sponsored coverage" that an employee is enrolled in for one or more months of a taxable year that begins after December 31, 2017. The monthly "excess benefit amount" is the plan cost that exceeds specific statutory cost limits (basic limits are $10,200/year for self-only coverage and $27,500/year for non-self-only coverage in 2018). An "employee" is an enrolled active employee plus any former employee, retiree or surviving spouse covered by the employer's high cost group health plan. The employer is responsible for calculating the excise tax liability, if any, but the tax is paid by the insurer of an insured health plan, the employer for a covered HSA/HRA, or the administrator of a self-funded plan.

The definition of "applicable employer-sponsored coverage" is one of the three primary topics of this notice. The two other key topics are 1) determining the cost of the applicable coverage and 2) how the statutory cost limits are applied to the cost of applicable coverage.

APPLICABLE EMPLOYER-SPONSORED COVERAGE

The notice lists the following group health benefits to be ***included*** as applicable employer-sponsored coverage in determining the cost of coverage:

- Medical and pharmacy coverage, regardless of the plan cost paid by the employer, i.e., can be 100% paid by the employee and still is included;
- Health FSAs (both employer and salary-reduction employee contributions);
- Employer health savings account (HSA) contributions and pre-tax employee HSA contributions (but employee after-tax contributions are excluded);
- Onsite medical centers, unless the benefits provided are de minimis;
- Retiree health coverage;
- Multiemployer health plans;
- Specific disease or illness, hospital indemnity or other fixed indemnity insurance plans that are funded on a pre-tax basis;
- Government health plans for civilian employees (excludes coverage for military personnel);
- Health reimbursement accounts (HRA) (proposed); and,
- Executive physical programs (proposed).
- The following benefits are listed as ***excluded*** from the cost of coverage:
- Insured dental or vision coverage;
- Accident or disability insurance:
- General, automobile and supplemental liability insurance;
- Workers compensation and similar insurance;
- Automobile medical benefit insurance;
- Credit-only insurance;
- Long-term care insurance;
- Specific disease or illness, hospital indemnity or other fixed indemnity insurance plans that are funded on an after-tax basis;
- Self-funded dental or vision coverage (proposed); and,
- Employee Assistance Plans (proposed).

The Notice suggests that de minimis onsite medical center coverage in this situation will be defined similar to COBRA regulations – where the health care provided primarily is first aid, immunizations, allergy injections, non-prescription pain relievers, or treatment of work-related injuries. The IRS asks for comments on this provision.

Interestingly, the notice recognizes that the law refers only to *insured* dental or vision coverage being excluded from applicable coverage, but makes the point that a plan’s funding arrangement (insured or self-funded) generally isn’t relevant in applying the law. Therefore, the IRS proposes to also exclude self-funded dental or vision coverage, but asks for comments.

COST OF APPLICABLE EMPLOYER-SPONSORED COVERAGE

In general, determining the cost of applicable employer-sponsored coverage for the Cadillac tax follows similar rules to calculating the COBRA applicable premium. However, the ACA section on Cadillac tax sets some specific, differentiating cost calculation rules, such as the excise tax payment expense itself can't be included in the cost calculation, retirees under age 65 and over age 65 may be grouped and treated as similarly situated participants, and specific rules for FSA and HSA costs. In addition, the notice mentions that a number of issues in calculating the COBRA premium have been left to interpretation up to now, and the IRS suggests they may use the Cadillac tax regulations to provide guidance and coordinate the approach for both calculations.

To add some ongoing mystery to determining cost of applicable coverage, the end of the notice has a short section asking for comments on whether the cost should be determined by the cost of similar coverage on a Health Insurance Exchange or by reference to available coverage elsewhere based on actuarial values, metallic levels or other categories. The IRS doesn't appear committed to these ideas, rather it is trying to consider all cost calculation alternatives before issuing final regulations.

Cost Calculation Methods

The COBRA applicable premium generally is based on the average cost of coverage for "similarly situated" participants under the employer's health plan for active employees, instead of determining cost by the individual characteristics of each participant. The premium must be calculated for a 12-month period (i.e., a determination period) and determined before the beginning of this period.
Two calculation methods of average plan cost are allowed for self-insured plans:

1. *Actuarial basis method*: This is the default method that typically establishes a minimum and maximum cost range based on factors defined by the Treasury Secretary (no regulations on these factors have been issued). For the Cadillac tax regulations, the IRS is considering whether to propose a broad standard under which the cost of applicable coverage for a group of similarly situated individuals would be equal to a reasonable estimate of the actual cost the plan would expect to incur for a determination period, instead of the minimum or maximum exposure the plan could have for that period. The IRS invites comments on all aspects of this approach, including whether a similar standard should apply for determining COBRA applicable premiums.
2. *Past cost method*: The basic COBRA rule is the applicable premium is equal to the plan cost for similarly situated beneficiaries for the same period during the preceding determination period(s), adjusted by a reasonable percentage increase or decrease in expected costs for the upcoming determination period. The IRS is considering adopting rules for both COBRA and the Cadillac tax that would allow plans to use any 12-month period ending not more than 13 months before the beginning of the current determination period as the 12-month measurement period for a current determination period. The IRS is also considering

regulations that would describe the costs that must be taken into account under this method, which could include:

a. claims (submitted or incurred);
b. premiums for stop-loss or reinsurance policies;
c. administrative expenses; and
d. reasonable overhead expenses of the employer ratably allocated to the cost of administering the plan.

The IRS invites comments on all aspects of this approach (e.g., should claim costs be based on submitted or incurred claims and the maximum length of time for a run-out period).

The IRS also is considering a rule for both COBRA premiums and Cadillac tax cost that the same calculation method must be used for at least five years, with limited exceptions for significant cost difference between periods. In addition, the IRS recognizes that by using the COBRA determination period and calculation rules means the Cadillac tax liability is known before the beginning of the “taxable” plan year, and is asking for comments on whether the Cadillac tax determination period should be the actual plan year and costs, e.g., the cost of applicable coverage in 2018 would be based on the actual plan costs for that 2018 plan year and not on trended costs of a prior determination period (like COBRA premium rules). The IRS acknowledges the feasibility of this actual cost approach may be driven by the filing and payment dates of the excise tax.

In addition, the IRS is asking for comments on how the cost of coverage under an HRA should be determined, reinforcing that the IRS anticipates that future guidance will include HRAs as applicable coverage for Cadillac tax purposes. Three approaches are being considered:

1. One suggested approach is to determine the HRA coverage cost based on the amounts made newly available to a participant each year, but not take into account carry-over amounts or amounts made newly available before 2018 (except for non-calendar plan years beginning in 2017 and running over into 2018).
2. Another alternative under consideration is to allow employers to determine an average cost of coverage by adding together all HRA claims and administrative expenses for the determination period and dividing that sum by the number of employees covered for that period at that level of coverage.
3. Thirdly, the IRS is considering whether to permit or require employers to use the actuarial basis method to determine the cost of HRA coverage.

Other HRA cost considerations are that the cost of applicable coverage should not include an HRA only used to fund the employee’s medical plan contribution (causes double-counting) and HRAs that can be used to cover a range of benefits (some of which are not applicable coverage) should be excluded. The IRS is seeking comments on these suggestions, particularly with respect to their administrative complexity.

SIMILARLY SITUATED INDIVIDUALS

In addition to the method of cost calculation, the other key factor in determining COBRA applicable premium is applying the costs of "similarly situated" individuals. The IRS anticipates that a similar standard will apply in the Cadillac tax context.

Under this approach, the IRS would start by considering as "similarly situated" each group of employees covered by a particular benefit package provided by the employer, and then subdivide that group based on proposed mandatory disaggregation rules explained in the notice, and allowing further subdivision of the group based on permissive disaggregation. The specifics of the approach being considered by the IRS are as follows:

- **Step 1 - *Aggregation by Benefits Package*:** "Benefit packages" would be differentiated based upon "differences in health plan coverage." According to the notice, a group health plan may consist of more than one benefit package. Employees would be grouped by the benefit packages in which they **enroll**, not by the packages they are offered. For example, employees enrolled in a standard option and a high option would be treated as separate benefit packages, as would HMO options and PPO options, and options within HMO plans and PPO plans.
- **Step 2 - *Mandatory Disaggregation based on self-only and non-self-only coverage*:** After grouping employees by benefits package, the employer would be required to disaggregate each grouping based on self-only coverage and other-than-self-only coverage. The ACA section on the Cadillac tax specifically differentiates only between these two coverage categories and the IRS has followed this structure.
- **Step 3 – *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 (e.g, employee + 1, employee + 2, etc.), even if the actual cost of coverage varies on this basis. This step means the costs for employees in various other-than-self-only coverage, such as employee + spouse, employee + dependents and family coverage, can be averaged into a single cost factor. On the other hand, an employer presumably would be permitted to disaggregate these groups, if desired. Whether employers use the permissive aggregation step may be a key strategy decision in minimizing their excise tax exposure – and it appears an employee contribution structure with three or more tiers still can be used to maintain current employee cost-sharing strategies.
- **Step 4 – *Permissive Disaggregation based on other factors*:** The IRS is considering permitting (but not requiring) further disaggregation based on distinctions that have traditionally been made in the group insurance market (e.g., bona fide employment-related criteria like nature of compensation, job categories, etc.). The IRS is also considering identifying more specific standards for permissive disaggregation, such as: current and former employees, geographic distinctions, and number of individuals covered in addition to the employee (i.e., different rating units).

The IRS is particularly interested in comments on this topic (the mechanics of the substantially similar approach), including areas in which additional guidance would be helpful. For example, the IRS asks for comments on: similarities and differences that should be considered in framing “benefits packages,” and which method of permissive disaggregation is preferable (e.g., broad standards v. specific standards). The IRS also seeks comments on how to apply the rule that retirees under the age of 65 and over the age of 65 may be treated as similarly situated beneficiaries.

APPLICABLE DOLLAR LIMIT APPLIED TO COST OF APPLICABLE COVERAGE

The ACA law establishes a self-only coverage annual dollar limit ($10,200 in 2018) and other-than-self-only coverage annual limit ($27,500 in 2018) as the basic thresholds on which the “excess benefit amount” is determined and the excise tax is applied. Because the “excess benefit amount” actually is determined monthly, the annual limits are pro-rated by month and determining whether an employee has self-only or other-than-self-only coverage for the month is based on coverage as of the beginning of the month. The law also included a number of potential adjustments to the annual dollar limits, which the notice mentions the IRS intends to set rules on but for now just asks for comments. Some of the adjustments are accepted, such as self-only coverage in a multi-employer plan is treated as other-than-self-only coverage, and the IRS asks for comments on these specific adjustments:

- Health cost adjustment percentage, based on actual cost increases up to 2018 and cost-of-living adjustments for subsequent years;
- Qualified retirees, specifically determining how an employer determines that an employee is not eligible for enrollment under Medicare;
- High-risk professions, primarily how an employer determines that a majority of employees are engaged in a high-risk profession and what’s an appropriate definition of a “high-risk profession”; and
- Age & gender adjustments, specifically whether it’s possible and preferred to set up safe harbor adjustment factors based on an employee group’s actual demographics compared to national workforce norms.

It is possible that an employer offers a combination of both self-only and other-than-self-only coverage (e.g., self-only major medical coverage and supplemental HRA coverage for the entire family). One of the IRS’s suggested approaches in this scenario is based on the employee’s “primary” or “major medical” coverage, which would account for the majority of the aggregate cost of the applicable coverage. So, for example, if an employee has applicable coverage costing $12,000 per year, $3,000 of which is self-only and $9,000 of which is other-than-self-only, the IRS would apply the other-than-self-only dollar limit to the full $12,000. If the self-only and other-than-self-only costs are split equally, the other-than-self-only limit would apply. The other potential approach is to apply a composite dollar limit determined by prorating the cost of self-only applicable coverage and other-than-self-only applicable coverage. The IRS seeks comments.

WHAT EMPLOYERS SHOULD DO

The notice provides employers with direction on how the future Cadillac tax regulations are likely to define applicable coverage and determine the cost of that coverage. If an employer is concerned about exposure to the Cadillac tax, it should use this guidance to fine-tune its 2018 plan cost projections based on enrollment (instead of availability) by benefit plan option, especially the individual cost impact of including HSA, FSA and/or HRA accounts (under various cost scenarios).

Unfortunately, this notice didn't help an employer determine the potential advantage of the various adjustments to the applicable dollar limit, and another notice is promised by the IRS covering other issues that likely impact the final determination of "excess benefit amount". So, if possible, we recommend continued patience in modifying current plan designs and options to get below the Cadillac tax dollar limits until the second notice is published.

Also, we recommend accepting the IRS invitation to share your comments about this notice. The comments must be submitted by May 15, 2015, to the following postal and/or email address:
CC:PA:LPD:PR (Notice 2015-16)
Room 5203
Internal Revenue Service
PO Box 7604
Ben Franklin Station
Washington, DC 20044

Notice.comments@irscounsel.treas.gov (include "Notice 2015-16" in subject line)

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