HUNTON& WILLIAMS

ACA UPDATE: GOVERNMENT ISSUES PRELIMINARY CADILLAC TAX GUIDANCE

The IRS recently issued Notice 2015-16 addressing the excise tax on high cost employer-sponsored health coverage enacted under the Affordable Care Act. This tax, commonly referred to as the "Cadillac" tax, will take effect in 2018. While it does not provide definitive guidance on which employers can rely, the Notice does provide some helpful insights as to the agency's intended approach regarding key aspects of the tax.

Section 4980I of the Tax Code imposes a 40% excise tax on the excess (if any) of the aggregate cost of an employee's monthly "applicable coverage" over the corresponding dollar limit for the month. Thus, the cost of coverage is to be determined, and the tax is to be applied, on a monthly basis. Note also that the tax applies to such coverage provided to former employees (such as retirees) and anyone else who is a primary insured under the plan (*e.g.,* surviving spouse or dependent separately electing COBRA coverage).

In general, the entity responsible for paying the excise tax is the health insurance issuer, under an insured plan; the employer, in the case of an HSA or Archer MSA; or the administrator, in the case of any other coverage. As a practical matter, though, it is likely that any such penalty payable by an insurer or third-party administrator will ultimately be borne by the employer or the plan in the guise of higher premiums or administrative fees. The statute also provides that the employer will be obligated to calculate the tax, inform the liable entities of their share and do any required IRS filings.

Notice 2015-16 primarily addresses (1) what may qualify as "applicable coverage"; (2) the determination of the cost of such coverage; and (3) the application of the annual statutory dollar limit for applicable coverage.

I. What is Applicable Coverage?

In general, "applicable coverage" includes both insured and self-insured group health coverage provided by an employer. And, to the extent that a health benefit constitutes applicable coverage, it is generally treated as such without regard to (a) whether the employer or the employee pays for the coverage, or (b) whether the employee pays for the coverage with after tax dollars.

As pointed out in the Notice, the statute explicitly provides that the following types of coverage are included in "applicable coverage:"

- Healthcare flexible spending accounts (FSAs);
- Health savings accounts (HSAs) and Archer medical spending accounts (MSAs) (see below regarding treatment of pre-tax and after-tax employee contributions);
- Governmental plans that are primarily for civilian employees;

- Coverage for on-site medical clinics (with potential exclusions for those that provide only *de minimis* medical care);
- Retiree coverage;
- Multiemployer plans; and
- Coverage for a specified disease or illness and hospital indemnity or other fixed indemnity insurance, if the payment for such coverage or insurance is excludible or deductible from gross income.

In addition, the Notice indicates that the government will likely take the position that executive physical programs and health reimbursement accounts (HRAs) will also be treated as applicable coverage.

At the same time, the Notice recognizes that, consistent with the statute, the following types of coverage are not considered to be applicable coverage:

- Workers' compensation;
- Accident or disability income, liability, automobile medical payment, credit-only or other insurance coverage in which medical benefits are secondary or incidental to insurance benefits;
- Long-term care coverage;
- Separate limited scope dental and vision insurance; and
- Coverage for a specified disease or illness and hospital indemnity or other fixed indemnity insurance, if payment for such coverage or insurance is not excludible or deductible from gross income.

The Notice also provides that further guidance will be provided in a number of areas, including the following:

1. *HSAs and Archer MSAs*. The IRS will propose to treat employer contributions to HSAs and Archer MSAs, including salary reduction contributions, as applicable coverage, but disregard employee after-tax contributions.

2. *On-site medical clinics*. The IRS currently intends to propose that applicable coverage will not include on-site medical clinics that offer only *de minimis* medical care to employees. The Notice requests comments on how to treat on-site clinics that provide certain services in addition to or in lieu of first aid (such as immunizations, allergy shots and nonprescription pain drugs).

3. *Limited scope dental and vision benefits*. As noted above, the statute only excludes separate dental/vision insurance coverage. The Notice indicates that the IRS will also propose excluding limited-scope self-insured dental and vision coverage that qualifies as an excepted benefit, and request comments as to any reason why they should not do so.

4. *Employee assistance programs (EAPs).* The Notice requests comment as to whether the regulations should exclude EAPs that qualify as an excepted benefit.

II. Determining the Cost of Applicable Coverage

In general, the statute provides that the cost of coverage is to be determined under rules similar to those used for determining the cost of coverage under COBRA. For purposes of the Cadillac tax, the aggregate cost of applicable coverage is based on the coverage in which the employee is enrolled, not the cost of any offered coverage in which the employee does not enroll.

Special Rules for Certain Types of Coverage

The statute contains some special rules for determining the cost of coverage for various types of coverage, including healthcare FSAs, HSAs and Archer MSAs. For healthcare FSAs, the coverage cost is equal to the sum of salary reduction contributions, plus any additional amount the employer has made available for reimbursement in excess of the salary reduction. For HSAs and Archer MSAs, the cost is equal to the amount of employer contributions, including salary reduction contributions.

Methods for Determining Cost of Applicable Coverage for Self-Insured Plans

In general, the COBRA regulations prescribe two methods for self-insured plans to compute COBRA premiums: the "actuarial basis method" and the "past cost method." For COBRA purposes, the IRS is considering requiring that plans use the same valuation method for at least 5 years (with certain exceptions), and the Notice requests comment as to whether a similar standard should be used under Section 4980I.

The IRS is also considering additional guidance on the standard for applying the actuarial basis method, the appropriate measurement period to use for the past cost method, and the types of costs that should be taken into account under the past cost method, and has requested comments on the proposed approaches for each. Comments are also requested on whether the method for determining the applicable cost of coverage should be elected before the determination period in question, similar to the requirements for determining the applicable premium under COBRA, and whether it would be feasible to base the applicable cost of coverage on the actual costs incurred for the year in question.

Identifying Similarly-Situated Individuals

The Notice provides that the cost of coverage will likely be based on the average cost for that type of coverage for the employee and all similarly-situated employees. The IRS is proposing an approach in which each group of similarly-situated employees would be determined as follows:

1. *Aggregation by benefit package* – The employer will aggregate all employees enrolled in the same benefit package, if there are multiple benefit packages

under the plan (*e.g.,* high deductible and standard options, HMO and PPO, or multiple options of the same type).

2. *Mandatory disaggregation for self-only and other-than-self-only* – The employer will be required to disaggregate participants with self-only and other-than-self-only coverage.

3. *Permissive aggregation within other-than-self-only coverage* – Within the group of employees with other-than-self-only coverage, The IRS has indicated that it may not require cost to be determined based on the number of other individuals covered (*e.g.,* employee plus one coverage, family coverage).

4. *Permissive disaggregation* – The IRS is considering whether to permit (but not require) further disaggregation based on (a) a broad standard (such as bona fide employment-related criteria) or (b) a specific standard (a list of limited specific categories).

HRAs

As noted above, the IRS intends to treat an HRA as applicable coverage for purposes of the Cadillac tax. The IRS is considering various methods for determining the cost of such coverage, and has invited comments on the proposed approaches, including treatment of HRAs that either (a) are limited to reimbursement for coverage costs or (b) can be used to pay for a range of benefits, some of which are not applicable coverage.

III. Determining the Applicable Dollar Limit

The dollar limits under the statute are $10,200 for self-only coverage and $27,500 for other-than-self-only coverage. The Notice provides that whether the self-only or other-than-self-only limit generally applies to any given employee will be determined based on the coverage provided to the employee as of the beginning of the month. As an exception, however, all coverage under a multiemployer plan will be treated as other-than-self-only coverage.

If an employee has both self-only and other-than-self-only coverage (*e.g.,* self-only major medical coverage and HRA coverage that covers family expenses), the proposed approach is to determine the applicable dollar limit based on the coverage that accounts for the majority of the aggregate cost of applicable coverage. Comments are requested on this proposal and an alternative approach that would be based on the ratio of the costs of the different coverage.

The dollar limits may be adjusted to determine the actual limits for 2018, and cost of living adjustments will apply for subsequent years. In addition, adjustments may apply – (i) for certain qualified eligible retirees, (ii) for plans in which a majority of employees covered by the plan are engaged in a high-risk profession or employed to repair or install electrical or telecommunication lines (or are retirees who were in such profession

for at least 20 years), or (iii) if the age and gender characteristics of the employer's workforce are different from the national workforce.

IV. Deadline for Comments and Subsequent Guidance

Comments on the issues raised in the Notice are due by May 15, 2015. The IRS plans to issue a second notice on other issues before issuing proposed regulations.