Agenda Item 9

August 18, 2015

ITEM NAME: Excise Tax on High Cost Employer-Sponsored Health Coverage

PROGRAM: Health Benefits

ITEM TYPE: Information

EXECUTIVE SUMMARY

The Excise Tax on High Cost Employer-Sponsored Health Coverage (excise tax) was established in the Affordable Care Act (ACA) and included in section 49801 of the Internal Revenue Code. This agenda item highlights the excise tax and its potential impacts on the California Public Employees' Retirement System's (CalPERS) health plans, employers, and members.

STRATEGIC PLAN

This agenda item supports Goal A: Improve long-term pension and health benefit sustainability by ensuring high quality, accessible, and affordable health benefits.

BACKGROUND

At the March 2015, Pension & Health Benefits Committee meeting, staff provided basic information about the excise tax and a point-in-time scenario to illustrate the impact of the excise tax on just two Health Maintenance Organization (HMO) plans in the Bay Area and Sacramento regions. The estimate for those two plans in those regions alone totaled $3.9 million in excise tax payments if the tax were in place today.

In May, staff apprised the Board of Administration (Board) in an oral report of a comment letter CalPERS submitted to the Internal Revenue Service (IRS) in advance of the IRS developing guidance on the excise tax. In this letter, CalPERS provided points to consider that exemplify CalPERS' unique position as a health benefits purchaser (not an employer) for active employees and retirees, and highlighted the complexity in implementing the tax for purchasers.

In today's agenda item, staff will discuss the components of the excise tax, outline strategies employers nationwide are considering to lower their health care costs, and provide a hypothetical illustration of the potential impacts of the tax on *all* CalPERS health plans throughout the state based on information currently available.

ANALYSIS

Excise Tax Overview

What Is It?

The excise tax (also known as the Cadillac tax) is a 40 percent tax on the aggregate cost of employer-sponsored health benefits, both fully-insured and self-funded, that exceeds annual dollar thresholds as defined by section 4980I(b)(3)(C) of the Internal Revenue Code. Beginning in 2018, the excise tax applies to the excess benefit, if any, above the following thresholds, indexed to inflation: $10,200 per year for individual coverage, and $27,500 per year for all other coverage (i.e., employee plus one, family coverage, etc.). The excise tax applies to all applicable employer-sponsored health coverage, regardless of employer size or plan type.

What Is Included in Applicable Coverage?

Per IRS Notice 2015-16, the following items are considered applicable coverage and subject to the excise tax:

- Employer and employee share of the total health plan premium
- Employer flex contributions used for Health Flexible Spending Arrangement (FSA)
- Employee pre-tax contributions to Health FSA
- Employer contributions to Health Savings Account (HSA)
- Employee pre-tax contributions to HSA
- Executive physical programs
- Health Reimbursement Arrangements (HRA)
- Governmental plans
- Multi-employer plans
- Retiree coverage

What Is Excluded from Applicable Coverage?

The following items are expected to be excluded from applicable coverage:

- Employee after-tax contributions to an HSA or HRA
- Long-term care coverage
- Stand-alone dental and vision coverage provided under a separate policy
- Excepted benefits, including workers' compensation, liability insurance, disability income insurance, and employee assistance programs

Who is Responsible for Calculating, Reporting, and Paying?

Employers are responsible for calculating the excise tax liability for each responsible party, including third-party administrators and health insurers. Employers also must notify each party of their portion of the tax liability and report this information to the IRS.

It is important to note that the parties responsible for paying the excise tax, called coverage providers, vary. For fully-insured plans, the health insurance issuer is responsible for payment. If an employee receives pre-tax employer contributions toward an HSA, HRA, or FSA, the employer or third-party vendor is responsible for payment, and for self-funded plans, the tax liability falls upon the plan administrator.

Each coverage provider must pay its pro-rata share of the excise tax based on the total cost of applicable coverage. This means that if a CalPERS contracting employer offers benefits in addition to the CalPERS health plan, and the combined value of the applicable benefits offered exceeds the threshold, the CalPERS health plan will be liable for their proportionate share of the tax, regardless of whether the plan's premiums are below the excise tax thresholds. Additionally, since the health plan premium will likely comprise the majority of the cost of applicable coverage, the plan will be allocated the majority of the excise tax.

It is anticipated that health plans subject to the excise tax will pass on the cost of the tax to members and employers via higher health plan premiums.

Employer Strategies

Employers across the country are considering various strategies to lower their health care costs and delay exceeding the excise tax dollar thresholds, including measures to:

- Limit HMO plan offerings and focus more on Preferred Provider Organization (PPO) plans (current statute identifies premium, but not co-pay and coinsurance as components of applicable coverage)
- Implement high deductible health plans and/or other cost-sharing options
- Decrease the availability of FSAs/HSAs/HRAs – or eliminate them altogether
- Offer health plans covering a lower percentage of allowable costs (lower actuarial value) to achieve lower health plan premiums
- Eliminate employer-sponsored health care, allowing employees to purchase coverage on the exchanges established by the ACA and receive subsidies where applicable, resulting in applicable large employer-shared responsibility penalty fees of $2,000 per employee (less the first 30) per year.

To assist the Board in understanding the potential impact of the excise tax on health plans, staff developed hypothetical scenarios (see Attachment 1) illustrating the potential dollar impact of the tax on CalPERS health plans for the years 2016, 2017, and 2018, based on our current understanding of the tax. The estimates are based on June 2015 subscriber enrollments and assume straight line annual premium increases of three and seven percent. The estimates illustrate excise tax impacts prior to accounting for additional benefits that may be provided by our contracting employers to their employees, and without accounting for IRS threshold adjustments (e.g. modifications due to high-risk professions, early retirees, age/gender, indexing, etc.). Taking into account what is known today, if the excise tax were in effect for 2016, based only on premiums, CalPERS health plans in total would incur an excise tax liability of approximately $14.4 million.

Information in the table below is based on the health plan premium alone and does not account for any other applicable coverage that may be provided by employers, nor does it account for any benefit design change. Again, this information is provided for illustrative purposes only, based on staff's current understanding of the excise tax. Attachment 1 also provides (by health plan and by region) the potential future impacts on CalPERS plans through 2018, when the excise tax takes effect. Taking only premiums into consideration and using the example of a straight three and seven percent rate increase in benefit years 2017 and 2018, the estimated total excise tax liability for CalPERS' health plans would be:

Premium Increase	Plan Year	Plan Year
	2017	2018
3%	$18.4 million	$26 million
7%	$25 million	$45.3 million

Based on the examples and assumptions outlined above, by 2018, staff estimate anywhere from $26 million to upwards of $45.3 million in excise tax liability, even at the most conservative rate increase estimates. Any excise tax allocated to our plans will likely result in higher rates for all CalPERS members and employers (State and contracting agency), as health plans may likely pass through the excise tax to members and employers.

As the IRS issues additional guidance and develops regulatory language around the implementation of the excise tax, CalPERS will educate members and communicate with employers to help them understand their roles and responsibilities. Staff will also take every opportunity to comment on each IRS solicitation to further highlight CalPERS' challenge in implementing rules that are geared primarily toward the employer community not health benefit purchasers such as CalPERS; the intricacies of CalPERS' health plans, regions, and population; and the impacts to our more than 1,300 contracting agency employers.

BUDGET AND FISCAL IMPACTS
Assuming a rate increase of seven percent over the next two years, staff estimate that by 2018, CalPERS' health plans could conservatively be responsible for as much as $45.3 million in excise tax payments directly attributable to premiums. Additionally, other benefits included in the aggregate cost of applicable coverage will generate an unknown liability for CalPERS' health plans.

BENEFITS/RISKS

The excise tax presents a number of risks to CalPERS, our health plans, employers, and members, some of which are outlined below:

- Greater premium increases: It is likely that health plans will pass on their excise tax liabilities to employers and members in the form of premium increases. This could result in contracting agencies choosing to leave CalPERS due to unsustainable premium growth.
- Administrative complications: Employers must calculate, on a monthly basis, the total tax and the share applicable to each responsible party, including health insurers and third-party administrators of other savings vehicles (FSAs, HSAs, etc.). Employers also must identify the individuals exceeding the dollar thresholds and notify CalPERS' health plans and the IRS in a timely manner. Since employers could face penalties for errors in calculating the tax, they may need to hire a third-party to verify that they have accurately allocated each responsible party's share.
- Unexpected liability: Coverage providers could face excise tax liability even if the value of the applicable coverage they provide does not by itself exceed the applicable dollar limits. Even if CalPERS diligently negotiates with health plans to keep premiums below the excise tax thresholds, employers could offer additional benefits (considered applicable coverage) to their employees. If the total value of all benefits exceeds the thresholds, the plans would be responsible to pay their pro-rata share of those excess benefits.

As outlined above, there are significant implications to CalPERS and our health plans if the IRS does not allow additional flexibility in the implementation of the excise tax.

ATTACHMENTS

Attachment 1 – Estimated Excise Tax Liability by Plan and Region 2016-2018
Attachment 2 – Excise Tax on High Cost Employer-Sponsored Health Coverage

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