The Cadillac Tax

The so-called Cadillac tax is one of the provisions in the Affordable Care Act (ACA) that may not have caught many people's attention as it doesn't come into play until 2018. However, 2018 is coming ever-closer and it's time for employers to pay attention to how it could affect them and their workforce.

The Rise of the Cadillac Plan

Under the ACA, the money that an employee pays for his or her healthcare through their salary is not taxed. This aspect of the tax code has encouraged employers to offer more and more expensive health insurance to their workers; as the money paid in is tax-free, it effectively incentivizes the purchasing of more expensive insurance packages.

This has led to a situation where plans could offer extremely small co-pays, sometimes as little as $5 per visit, and 100% coverage. The appeal of these so-called "Cadillac plans" is obvious. For an employer, they are able to include a great healthcare package in their offer to potential new employees; for an employee, they are getting excellent healthcare tax-free.

However, a drawback of this kind of plan soon became evident. With the low cost of healthcare access, policy holders—especially those with PPO plans—had complete access to a whole range of specialists at very little cost. An over-burdened healthcare system was the inevitable result.

What Is the Cadillac Tax?

The Cadillac tax, as it currently stands, has two specific aims:

1. Cut down on the excesses of "Cadillac health plans"
2. Contribute to paying for the ACA

It's important to note that the final regulations for the Cadillac tax have not been issued, so they are subject to change. However, as things stand now, this is what the tax looks like.

In 2018, an employer will have a dollar cap on healthcare premiums that he or she can provide to an employee as a tax-free benefit. For a single person, it is currently set at $10,200; for a family, it is $27,500. Any amount of funding on the employer's or employee's part in excess of this amount will be taxed at 40% excise tax, which is nondeductible to the employer.

The intended aim of this is clear: to cut down healthcare costs in the U.S. by reducing inefficient utilization of healthcare as a resource.

A second aim of the Cadillac tax relates to how the Affordable Care Act is funded. Although there have been taxes embedded into the ACA since its introduction, the Cadillac tax would significantly increase revenue to the government if employers don't make drastic changes to their plans.

An Imperfect Solution

Clearly the present system is inefficient and needs to be reformed. Cadillac plans encourage misuse of what is a finite resource; there has to be a cap of some kind on tax-free benefits. However, the Cadillac tax in its current incarnation doesn't fix the problem.

Concerns about the current form of the tax are spread across financial and political boundaries: employers are concerned, as are workers with families, and unions. In its present form, the Cadillac tax is somewhat draconian. There is, for example, an obvious potential for the tax to penalize families with multiple children. The family cap is $27,500, regardless of how many children are included (or if a couple has children at all). Families will then be hit harder depending on whether they have children, and then on how many children they have.

Having a specific dollar amount to apply to healthcare costs, regardless of where you are in the country, seems unfair to many. One of the most significant flaws in the Cadillac tax method is that the dollar amount at which costs are to be capped is the same across the country, whether you live in a high-cost area or a low-cost area. So if you live in Nebraska, $10,200 might be sufficient for a single person's costs; in, for example, New York, or any other high-cost area around the country, that amount may not get you very far, especially in 2018 dollars.

States and metropolitan areas with higher costs of living will be hit disproportionately hard—and this is the opposite of the stated intent of the tax.

Instead of this clear imbalance between people who live in different parts of the country, one possible solution is to base it on the actuarial value of the plan instead of on the cost of the plan. Medicaid and Medicare use a very sophisticated system of measuring what actuarial value is, as part of the ACA. This could be applied to the Cadillac tax, giving everyone in the country an 80% actuarial plan, basically as a tax-free benefit. Anything beyond that would be regarded as taxable. This would seem to be a much fairer way to approach the problem.

What Happens Next?

The Cadillac tax will almost certainly change before it comes into being in 2018. This doesn't mean that clients shouldn't be concerned about it—or that they can put off thinking about it. If you're working with a good consultant, you should already be planning ahead and coming up with a plan on how to react to whatever is coming down the line.

Talk with your benefits adviser about the Cadillac tax and anything else on the horizon: the sooner you plan, the better you'll be able to deal with the many complex issues that the ACA brings.