

Avoiding a Collision  
*How to Swerve, Stop, or Straddle  
Exposure to the “Cadillac” Tax*



*An Informative Article on the Obamacare Cadillac Tax  
For Forward-Thinking Organizations*

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Throughout automotive history, the Cadillac brand has undergone several changes in brand perception from ultra-luxury to gas guzzling barges to its current urban-hip. One might speculate that the final tax of the Patient Protection and Affordable Care Act (ACA or Obamacare), nicknamed the “Cadillac tax,” is supposed to make the mandate more palatable to beleaguered taxpayers.

**The Cadillac tax takes effect in 2018, requiring organizations to steer carefully to avoid the 40 percent non-deductible excise tax on that portion of high-value employer-sponsored health coverage that exceeds certain cost thresholds,** and applies to both employees and retirees. And despite the label, more than “luxury” plans are affected.

Not surprisingly, the Cadillac tax is a Robin Hood way to help pay for the ACA health coverage expansion. **The Congressional Budget Office projects this tax will generate \$87 billion of revenue from implementation in 2018 through 2025.** A recent Ernst & Young LLP poll suggests that many companies remain unprepared. Surveyed executives report that 73 percent of companies have yet to model the impact of the tax on their healthcare plans, while 53 percent have yet to consider changes to their benefit offerings<sup>1</sup>.

The Cadillac tax’s benefits-cost thresholds for 2018 rest at \$10,200 for self-only coverage and \$27,500 for family coverage, with some limited adjustments to be indexed each year after 2018, based on general inflation. Those organizations with the following characteristics will be subject to the tax earlier than others:

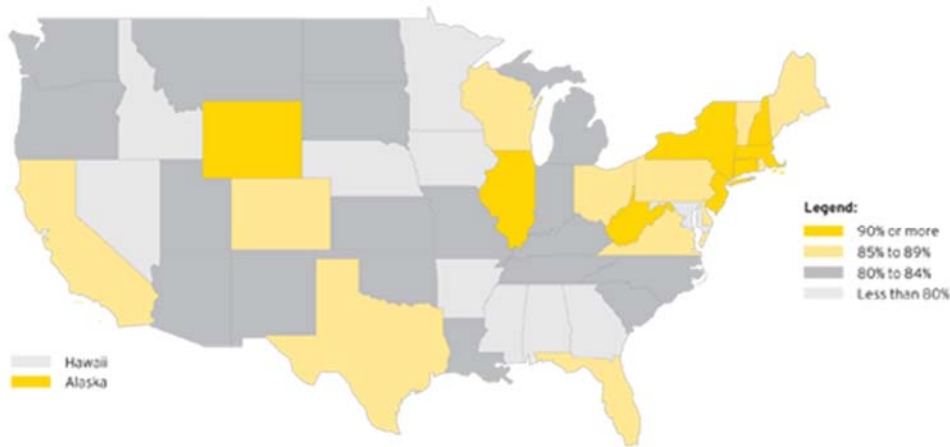
- Located in areas with higher healthcare costs, (the Northeast) will be subject to the tax sooner than those offering comparable plans in lower cost regions (see map below)
- Historically offered high-cost benefits
- With older or sicker workforces
- Greater numbers of early retirees
- Professionalized workforces
- Unionized employees<sup>2</sup>

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<sup>1</sup> Ernst & Young LLP, April 2015 survey of 1,000+ tax and finance executives.

<sup>2</sup> <http://www.ey.com/GL/en/Issues/Governance-and-reporting/EY-the-cadillac-tax-is-coming>

**Projection on How the Cadillac Tax Applies Across the United States:  
Projected Average Total Base Medical Premium in 2025 as a Percent of  
Projected Excise Tax Threshold<sup>3</sup>**



An obvious first question: ***Will shifting premium costs to employees reduce the tax? No.*** The Cadillac tax will be assessed on the cost of specified healthcare coverage that exceeds the threshold. The **cost includes** both employer and employee premium contributions in the following programs:<sup>4</sup>

- Insured and self-insured group health plans (including behavioral and prescription drug coverage)
- Wellness programs that are group health plans (most wellness programs)
- Health Flexible Spending Accounts (FSAs)
- Health Savings Accounts (HSAs), employer, and employee pre-tax contributions
- Health Reimbursement Accounts (HRAs)
- Archer Medical Savings Accounts (MSAs), all pre-tax contributions
- On-site medical clinics providing more than de minimis care
- Executive Physical Programs
- Pre-tax coverage for a specified disease or illness
- Hospital indemnity or other fixed indemnity insurance
- Federal/State/Local government-sponsored plans for its employees
- Retiree coverage
- Multi-employer (Taft-Hartley) plans

<sup>3</sup> <http://www.ey.com/GL/en/Issues/Governance-and-reporting/EY-the-cadillac-tax-is-coming>

<sup>4</sup> <http://www.cigna.com/aboutcigna/informed-on-reform/cadillac-tax>

The **cost excludes** the following<sup>5</sup>:

- U.S.-issued expatriate plans for most categories of expatriates
- Coverage for accident only, or disability income insurance, or any combination thereof
- Supplemental liability insurance
- Liability insurance, including general liability insurance and automobile liability insurance
- Worker's compensation or similar insurance
- Automobile medical payment insurance
- Credit-only insurance
- Other insurance coverage as specified in regulations under which benefits for medical care is secondary or incidental to other insurance benefits
- Long Term Care
- Stand-alone dental and vision
- Coverage for the military sponsored by federal, state or local governments
- Employee Assistance Programs
- Employee after-tax contributions to HSAs and MSAs
- Coverage for a specified disease or illness and hospital indemnity or other fixed indemnity insurance, if payment not excluded from gross income

***How can organizations avoid paying the Cadillac tax?*** Here is a roadmap for your organization to consider:

- First, quantify the cost exposure of the Cadillac tax from existing benefits
- Next, consider a solution set of one or more of these cost-saving strategies:
  1. For rank and file employee benefits:
    - Move to a private exchange
    - Move to a captive or self-insurance model
  2. For highly compensated employee and executive benefits:
    - Shift existing benefits to those excluded from the Cadillac tax
    - Shift existing benefit dollars to deferred compensation plans

Please read on for details on each of these strategies.

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<sup>5</sup> <http://www.cigna.com/aboutcigna/informed-on-reform/cadillac-tax>

## Quantifying the Cost

What is your organization's exposure to the 40 percent non-deductible Cadillac tax?

Forward-thinking health insurance brokerage HUB International has created a [Cadillac Tax Calculator](#) and a [Cadillac Tax Checklist](#) to help determine the cost exposure you may face.

Of course, companies that incorrectly calculate the tax will be liable for a penalty equal to the amount of the underpayment, plus interest. Your health insurance advisor can help you work through the total cost and exposure to your company.

You'll find instructive this example of the Cadillac tax cost for a 500 employee company:

- 500 employee company—half of the employees have self-only coverage and half of the employees have family coverage
- 250 employees with self-only coverages of \$12,000 per year—**\$12,000 - \$10,200 = \$1,800 above the \$10,200 threshold; \$1,800 x 40% = \$720 in Cadillac tax per employee; \$720 x 250 employees = \$180,000**
- 250 employees with family coverages of \$32,000 per year—**\$32,000 - \$27,500 = \$4,500 above the \$27,500 threshold; \$4,500 x 40% = \$1,800 in Cadillac tax per employee; \$1,800 x 250 employees = \$450,000**
- **Total Cadillac tax cost to this company would be \$180,000 + \$450,000 = \$630,000 per year, plus annual escalations.**

## Cost-Saving Solutions to Consider—Rank and File Employees

### Move to a Private Exchange

ACA includes a provision mandating the creation of insurance exchanges for individuals not covered by their employers. The exchanges are places where consumers can comparison shop for a health plan, democratically, as it were.

Private exchanges provide a platform for employees to be able, for the first time, to choose between numerous health plans, rather than to choose from the traditionally limited selection of group plans chosen for them by their employer. A private exchange gives employers the ability to offer more choice, vis-a-vis more plans; traditional plans are likely

to be far more expensive because costs are amortized to account for the sickest members. One of the main selling points of private exchange concept is the decision support tools for employees to help choose the best plan, instead of the “same plan I had last year.”

A private exchange provides employees with the advantages of group coverage and gives them a real market like an exchange, where they can act like consumers and shop and purchase plans that they want—not just what their employer offers. Hixme, a private exchange provider, acts as a benefits consultant to these employers with 500 or more employees, helping them migrate their employees to the exchange. Recently, Kleiner Perkins Caufield & Byers led a \$10.5 million Series A round for Hixme, indicating that the private exchange route offers some staying power.

#### Move to a Captive or Self-funded Health Insurance Model

Self-funding offers another way for larger organizations to fund health benefits efficiently. By assuming part or all of the risk of employees’ healthcare costs, employers stand to achieve savings of 5-15 percent from self-insuring with the following advantages, per [Spring Consulting Group](#):

- **Retain and Redeploy Health Plan Marketing and Retention Fees.** All health insurers include expenses loaded in their fully-insured premiums for new business sales, marketing expenses, and retention of current customers. These costs can be as high as 2 to 4 percent depending on the carrier; they do not exist in a self-funded environment other than a de minimis amount of cost built into stop-loss insurance if used.
- **Clarify and Control Administrative Costs.** The cost to administer benefits, pay claims, maintain a network and provide for the overall operation of the health plan can equal 10 to 12 percent of insured premiums. While self-funded employers will incur administrative expenses through payment to a carrier, third-party administrator (TPA) or Administrative Services Only (ASO), they can control these expenses through multi-year guarantees, transparent and unbundled agreements, marketing the plan administration contract every three to five years, and identifying the most cost-effective administrative carriers in the marketplace.

- **Capture and Invest Reserves.** Since the money for claims comes from the operating income of the employer, a self-insured employer can capture investment income accrued on all funds allocated to the funding of insurance claims. This interest can be used to offset benefit costs or administration.
- **Receive a Cash Flow Advantage as the Self-Funded Plan Reaches Maturity.** For employers moving from a fully-insured model to self-insurance, there will be a period of two months or so before claims mature. The fully-insured claims run out will be covered by the previous carrier. During this initial period, an employer should bank the excess cash to use for future claim liabilities. Incurred but not reported (IBNR) reserves need to be calculated on a quarterly basis or loaded into the premium to account for the IBNR claim liability.
- **Capitalize on Savings from Positive Experience.** For the years in which healthcare claim costs are below expectations, employers can add those savings directly to the bottom line of their profit and loss statement. With the passage of the ACA and proliferation of state healthcare mandates, employers are focused more than ever on ways to curb utilization costs. Methods include implementing tools such as consumer-directed health care, increased cost sharing, claim price transparency tools, specialty networks, value-based plan designs, and wellness programs. Self-funding can enhance these strategies by providing an employer with more leeway on how they design and fund such programs. Additional spending on appropriate strategies can generate an identifiable return on investment that goes to the employer and not the insurer.
- **Create Advisor Fee Transparency.** Many insured employers do not understand the full cost of an advisor as the commissions are loaded in the fully-insured rates and often invisible to the employer. By self-insuring, employers see the breakdown of costs their advisors charge and can manage those costs by implementing a fee-based or commission-based structure to fit the employer's needs.



- **Understand Population Health Risk and Cost Drivers.** Access to claim information under a self-insured model allows employers to begin to analyze the health conditions and high-cost chronic disease states resident in their population. Based on these findings, targeted programs can be implemented to impact costs. Obtaining detailed claim information in a fully-insured environment is challenging, if not impossible, because of privacy concerns and the fact that carriers do not consider this data employer property.<sup>6</sup>

## Cost-Saving Solutions to Consider—Highly Compensated and Executive Employees

Executive Benefit Solutions advises leading organizations of all types and sizes on how to attract, retain, reward, and motivate key talent using well thought-out strategies such as nonqualified executive benefit plans. Present and past clients include 200 of the Fortune 500, leading tax-exempt organizations, and a wide range of middle-market organizations. We intend to share the details on how organizations can mitigate the risk of the Cadillac tax by shifting dollars to well-designed executive benefit plans.

An organization's highly compensated and executive-level employees have the means, and most likely, the motivation to continue to pay for rich benefits and to seek tax-deferral strategies. Rank and file employees may not have the means. This situation is called an executive benefit carve-out. Here are some executive carve-out strategies to consider.

### Shift Existing Executive Benefits to HIPAA-excepted

As noted above, some benefits are all HIPAA-excepted<sup>7</sup>, which means that they do not count in the Cadillac tax calculation. These benefits include<sup>8</sup>:

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<sup>6</sup> <http://www.springgroup.com/self-funding-health-insurance-and-the-management-of-risk-white-paper/>

<sup>7</sup> HIPAA refers to the Health Insurance Portability and Accountability Act. For the purposes of health care reform, certain kinds of coverage are designated as "excepted benefits."

<sup>8</sup> <http://www.unum.com/HealthcareReform/Benefits.aspx>



- **Accident:** Accident insurance helps protect employees by paying lump sum benefits based on the injury and treatment they receive. Plans include a schedule of benefits outlining the amount paid for broken bones, stitches, necessary emergency room visits and other treatment. It also includes additional benefits for crutches, physical therapy, and other medical expenses.
- **Critical Illness:** ACA eliminated the annual and lifetime maximums for many benefits and the rescissions of coverage that often meant medical bills of \$100,000 or more for those who survived cancer or other serious illness. But the law does allow co-pays, co-insurance and deductibles that can add up. And there are other expenses during treatment that major medical insurance doesn't cover, such as:
  - Additional childcare
  - Travel and lodging to a treatment facility in another city
  - Alternative treatments
- **Disability Insurance:** Group disability plans have limitations and often exclude total compensation. The group disability plans also offer a multiple of salary with some monthly cap— 66.67 percent of salary with a cap of \$15,000—which results in a large income gap for highly compensated employees. Today, organizations design supplemental plans to fill the void. The benefits are based on total compensation, as well as the value of stock options.
  - Individual short term disability is a voluntary disability plan. It can pay a percentage of an employee's income for weeks or months if needed.
  - Individual disability insurance for highly compensated workers can provide additional coverage for income that might be lost due to benefit maximums on long-term disability plans. It also can help cover bonus, commission and other incentive income that may not be covered by all basic plans.
- **Life Insurance:** Regardless of the impact of health care reform, families need this financial protection in case a primary wage earner dies during their working years. In



addition to a death benefit, some life policies also can help employees deal with the expense of a terminal illness or a period of long-term care. In connection with sound financial and estate planning, life insurance programs that provide income replacement are not uncommon at executive levels. Most basic group plans offer limited opportunity to provide significant levels of death benefit protection. The disconnect between an organization's life insurance policy and its total compensation and benefits strategy occurs when the bulk of an employee's compensation is derived from bonus and incentive pay while the group life plan delivers a benefit based on a multiple of salary (1.5 times the salary with a cap of \$200,000). As a result, organizations that offer a total compensation package that emphasizes security and flexibility should consider providing supplemental life insurance protection as a multiple of total compensation for its top management. The rule of thumb is three to five times the total pay with no cap.



- **Group Hospital Indemnity Insurance:** With the rise in cost-sharing and medical costs, a hospital stay or surgery can devastate an employee's finances. Deductibles and co-insurance can leave a worker responsible for 20 percent or more of a bill that could total tens of thousands of dollars. You can help alleviate this worrisome burden by offering group hospital indemnity insurance, which can pay benefits for:
  - Hospital stays
  - Outpatient and inpatient surgery
  - Emergency room visits
  - Ambulance or air ambulance transportation
  - Diagnostic tests
  - Wellness benefit

#### Shift Benefit Dollars to Deferred Compensation Plans

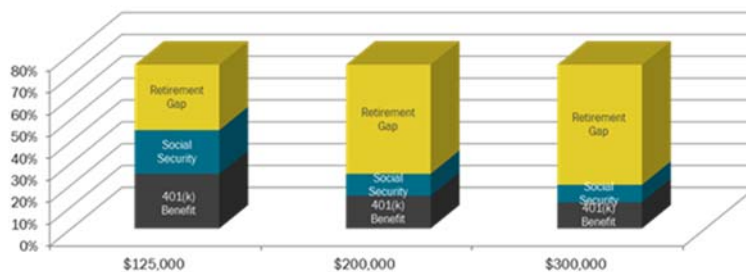
Organizations can shift benefit dollars from health-based benefits to compensation-based benefits. Namely, deferred compensation plans with company matching and vesting that shift

the executive’s Cadillac tax driven benefits into a non-Cadillac tax effecting a robust retirement program that also puts “glue in the seat” as an executive retention strategy.

Let’s begin with a basic understanding of the gap in retirement income faced by high-income earners. Organizations face limits on the types of benefit plans they are permitted to offer compensated employees. While qualified retirement plans like a 401(k) or 403(b) build a good foundation, they have their limits. See the chart<sup>9</sup> below:

Retirement Plan Contribution Limits			
Year	Plan	Age 49 & Below	Age 50 & Above
2015	401(k)	\$18,000	\$24,000
2015	403(b)	\$18,000	\$24,000
2015	457(b)	\$18,000	\$24,000
2016 (est)	401(k)	\$18,500	\$24,750
2016 (est)	403(b)	\$18,500	\$24,750
2016 (est)	457(b)	\$18,500	\$24,750

As income levels of executives increase, the gap in retirement income that must be filled by personal savings increases. The following table<sup>10</sup> demonstrates this effect:



Assumptions:

- Age 45; retirement age 65
- 401(k) starting balance \$50,000; contributions to max under laws
- Salary increases 4% social security; includes 3% annual cost of living adjustment
- 7% investment return

<sup>9</sup> Source: <http://www.savingtoinvest.com/taking-advantage-of-new-401k/>

<sup>10</sup> Source: Executive Benefit Solutions

Executive benefits should integrate into an organization's **total rewards program** to ensure desired performance of executive participants. In reality, many executive benefit alternatives cost far less from an accounting standpoint. What's more, these benefits can be designed to drive the right behavior of the participants in the plan.

### **Overview of Executive Benefits**

Executive benefits are often regarded as extra compensation; that is, payment over and above salary, bonus, and equity. Consequently, boards, shareholders, and the media alike scrutinize executive benefit plans more than ever. Therefore, it is important to use an objective basis and process to determine which of the many possible benefits make good business sense.

It is equally important to know how these benefits can help or hurt an organization's ability to attract, retain, reward or motivate those key employees who make a difference in your firm.

### **Risk of Tax-Rate Increase**

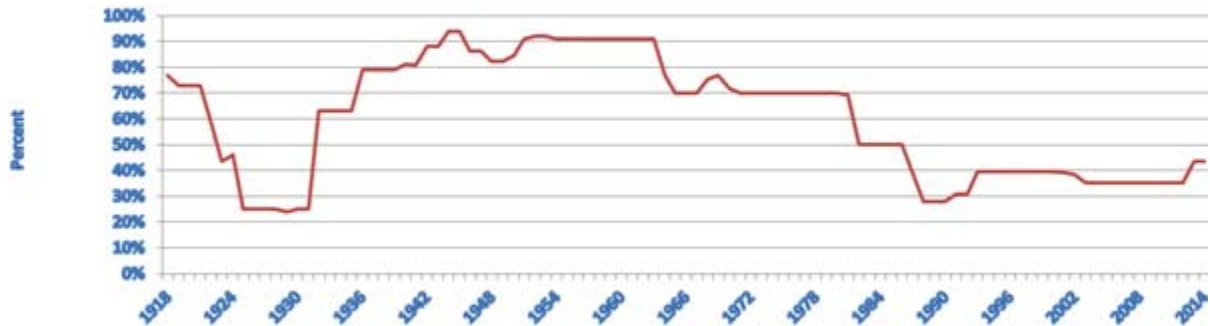
Tax-deferred plans have lost some of their appeal due to the risk of future tax rates. If you think tax rates will rise, then why defer compensation today, only to receive it at a higher rate in the future? Today, most executives focus on distribution rather than accumulation because *"it's not how much you make, but how much you keep."* The distribution phase of your retirement planning (when you withdraw from the plan), could be the most important phase.

No one knows what income tax rates will be when they retire (see chart below<sup>11</sup>). Moving from a 35 percent tax bracket is a direct and painful reduction in your retirement income. However, there are alternatives which can produce non-taxable income at retirement discussed in the text ahead.

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<sup>11</sup> Source: [http://bradfordtaxinstitute.com/Free\\_Resources/Federal-Income-Tax-Rates.aspx](http://bradfordtaxinstitute.com/Free_Resources/Federal-Income-Tax-Rates.aspx)

## Top Federal Tax Rates








Deferred compensation forms the core of executive benefits. If designed optimally, it can be one of the lowest cost benefits that align the interest of executives with those of shareholders. The use of deferred compensation causes no dilution in ownership, nor does it cost the organization significant dollars to provide.

In a deferred compensation arrangement, executives are offered the option of deferring their compensation into tax-advantaged accumulation accounts. Comprised of the same compensation dollars, these accounts would have otherwise been paid in salary or bonus or benefits.

A typical nonqualified deferred compensation plan (NQDC) allows executives to defer 80 to 90 percent of their base salary and 100 percent of their annual incentive awards. The deferrals accumulate and grow at a set rate of interest or at a rate of return determined by some form of investment such as a mutual fund.

For many organizations, the primary objective of these programs is to offer an additional vehicle to facilitate wealth accumulation, as well as tax and portfolio management opportunities. NQDC plans today are more like a “tax-deferred cash management” program, giving the executive an opportunity to plan for his or her life events, such as college tuition for his children or his retirement.

The following chart illustrates a 40-year old executive who elects to defer 12 percent of his \$175,000 salary and 20 percent of his \$100,000 bonus.

EXAMPLE					
Participant: Age 40 / Two Children: Ages 13 & 11					
Base Salary:	\$175,000	Salary Deferral:	12%	Deferral Amount:	\$21,000
Bonus:	\$100,000	Bonus Deferral:	20%	Deferral Amount:	\$20,000
				Total Deferral:	\$41,000
	20%	20%	10%	25%	25%
	\$8,200	\$8,200	\$4,100	\$10,250	\$10,250
					
	College	College	Boat	Retire	Retire
	Payout 2018	Payout 2020	Payout 2024	Retirement	Retirement
Distributions	4 years	4 years	Lump Sum	15 years	Lump Sum
Asset Allocation	Conservative	Conservative	Aggressive	Moderate	Moderate

You will notice, he set up five “buckets” with various distribution dates. The first election is 2014, set up as a college fund for his son contributing 20 percent of his election, electing a distribution of four years beginning in 2018.

The second bucket was designed for his daughter who anticipates college in 2020. After the kids are out of school, he plans to buy a boat, so he elected to defer 10 percent of his contribution election until 2024. Each bucket also allows him to set up his asset allocation<sup>12</sup> based on the risk he is willing to take.

And finally, he set up two retirement buckets: one designed for a lump sum payout, and the other for distribution over 15 years. There are tax benefits when you tax distribute over more than a 10-year payout. The tax benefits allow you to retire in a lower tax state than the one in which you deferred the compensation, for example, deferring in California and retiring in Nevada where there are no state taxes.

<sup>12</sup> Asset Allocation does not guarantee a profit or protect against a loss in a declining market. It is a method used to help manage investment risk.

## **Deferring Taxes**

An NQDC plan is a valuable tool for management to align its interests with its shareholders. As cited earlier, an organization may decide to use such a plan to attract key employees, or let it serve as a parking place for signing bonuses with “golden handcuff” vesting requirements.

Finally, an organization may use such a plan as a retention tool offering an organizational match that vests years in the future. The reason these plans are so prevalent is that the cost of offering such an arrangement is negligible due to the use of various funding vehicles. These plans provide executives with the advantage of tax-deferred savings and investment growth.

## **Next Steps**

The essential first step: Take inventory of what your organization offers then match it to employee levels, whether executive, frontline or mid-level employee. To balance existing benefits, Cadillac tax-driving benefits, and executive carve-out benefits will require a considerable amount legwork. You may wish to consider retaining a professional service provider, specializing in healthcare benefits, to assist you in making the transition.

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For more information on how to handle the Cadillac tax, please contact one of our advisors:

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