The Cadillac Plan Tax: The Well-Heeled Origins of a Misguided Proposal

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Earlier this week, sweeping health care legislation was passed by the U.S. House of Representatives without much time for discussion regarding what actually is included in the bill. Since mid-2009, a number of key provisions to be included in such reform have been widely talked about among media and legislators, including eliminating pre-existing condition requirements in health insurance contracts, medical malpractice caps, and “Cadillac Plans,” also known as “gold-plated plans.”¹ These high-cost insurance policies can offer low deductibles and excellent benefits that cover most treatments, but that is not always the case. They are defined as such by the total cost of premiums paid – not necessarily what is actually covered in the plan. Senator Max Baucus, chairman of the Senate Finance Committee, proposed placing as much as a 40 percent excise tax on these Cadillac Plans in an effort to raise money for the health care reform legislation.² Senator Baucus got his wish. The recently-passed healthcare bill imposes a 40 percent excise tax on premiums paid costing more than $27,500 annually for a family, beginning in 2018.³ Though the implementation of the tax is a number of years away, it’s important to understand the history and unnecessary complexity of the Cadillac Plan tax.

Design of the Cadillac Plan Tax

At its core, the Cadillac Plan tax is an excise tax on insurance companies, plan administrators and employers if they self insure and act as plan administrators for insurance, flexible spending accounts (FSAs), or health reimbursement arrangements (HRAs), based on certain health-related benefits provided to workers (hereinafter “employee sponsored health benefits” or “ESHB”). Although media reports have often described Cadillac Plan coverage as catering to the extremely wealthy, with premiums costing up to $40,000 annually, that is not the case. Often, some union workers, older and sicker Americans, and other employees with expensive to treat illnesses have premiums in the Cadillac range.

The tax is calculated based on an amount in excess of a threshold applied to each employee’s aggregated ESHBs.⁴ This calculation includes insurance premiums paid directly by the employee as well as those paid by the employer on behalf of the employee, but only includes contributions by the employer or pretax dollars for the FSA,

² Id.  
⁴ Health insurance premium, vision insurance premium, dental insurance premium, any other supplementary health insurance premium and the employer’s contribution to health savings accounts (HSAs), HRAs and FSAs.
HSA and HRA. Thresholds for family plans are greater than those for individual plans. The passed legislation defines a high-cost individual plan as exceeding $10,200 annually and a family plan exceeding $27,500 annually.\footnote{See America’s Healthy Future Act of 2009 and Patient Protection and Affordable Care Act}

Under the plan, an employer bears the rather burdensome responsibility of aggregating the ESHBs each month and determining the pro rata share for each entity that will pay the excise tax. The employer must then provide notice of same to the IRS, the employee, and to each tax-paying entity. Each insurer, plan administrator or employer calculates and pays its pro-rata share of the excise tax for each employee whose aggregated benefits exceed the threshold. If an employee’s ESHBs included health, vision and dental insurance through three different insurers and an FSA by the employer, four entities will proportionally pay the 40 percent excise tax on the amount in excess of the threshold.

The purpose of the Cadillac Plan tax is twofold: (1) to increase federal revenues and (2) to “bend the cost curve.” Advocates argue that the plan will change incentives in the health system and move employers and employees to more efficient plans as well as increase salaries. Plan detractors say workers will be moved to plans with less coverage and more out of pocket expenses.\footnote{Kaiser Family Found., Focus on Health Reform, http://www.kff.org/healthreform/upload/healthreform_tri_full.pdf (last updated Oct. 15, 2009).} While there is no direct impact on the income taxes of employees, workers’ income taxes could be higher if compensation were shifted from benefits to salary. There is no direct impact on the income taxes of the employers – they receive the same tax deduction to their own income taxes whether they compensate employees with a dollar of salary or a dollar of health benefits. However, since the value of employer-sponsored insurance (ESI) is not used in calculating payroll taxes the employer’s \textit{payroll} taxes would increase if the employee’s salary increases.

Finally, even though an excise tax based on “high cost” individual plans would also satisfy the twofold purpose (raise revenue and bend the cost curve), it was not proposed. The reason lies in the roots of the plan discussed below.

**Roots of the Cadillac Plan Tax: The Personal Income Tax Exemption for ESI**

Prior to July 2009, the debate over the Cadillac Plan tax focused on the advisability of modifying or eliminating the long-standing personal income tax exemption for employer-sponsored insurance (ESI). That is, while the value of vehicles, bonus trips and other in-kind payments to employees were estimated and added to the employee’s W-2 as employment income, health benefits were not treated as income to the employee. Economists estimate that $245 billion in federal revenue is lost each year due to the exemption.\footnote{Kaiser Family Found., Focus on Health Reform, Explaining Health Care Reform: How Might a Reform Plan Be Financed?, (July 2009), http://www.kff.org/healthreform/upload/7947.pdf (citing É. Kleinbard, Summary of Testimony for Senate Finance Committee Hearing, Health Benefits in the Tax Code: The Right Incentives, (July 31, 2008), available at http://www.jct.gov/publications.html?func=startdown&id=1194.} If the tax exemption were capped at the level of the standard option plan
under the Federal Employee Health Benefit Plan (FEHBP), it would generate an additional $418.5 billion in revenue over ten years.8 In addition to the evident appeal as a revenue enhancer, limiting the exemption was claimed to “bend the cost” curve – the very two goals that politicians were finding so elusive.

The ESI exemption from gross income for employees dates back to the 1920s,9 a time when “(n)either medicine nor health coverage was very advanced (and) (t)he average day in the hospital cost only a few dollars, and physicians did not charge – or earn – large amounts.”10 By the 1940s and 1950s, group health coverage as a fringe benefit became commonplace, especially in union-organized businesses, and the IRS codified its earlier administrative decisions into the Internal Revenue Code of 1954, thus further encouraging the growth of ESI.

Historically, there have been many reasons for encouraging employers to negotiate and pay for health insurance for their employees. ESI offers many employees and their families affordable insurance with guaranteed issue and with COBRA and HIPAA protections. A large employer is also better able to negotiate with an insurer than an individual, thus driving costs down – a goal not only for employers and employees, but for those interested in decreasing the overall costs of health care. Moreover, ESI offers the insurer the convenience of contracting with an employer and thus likewise encourages employee participation in these plans. In fact, approximately 160 million people in the United States (60 percent of those under the age of 65) receive health insurance coverage as an employer benefit, either as the employee or the dependent of an employee.11 Employers pay an average of 84 percent of premiums for individual coverage and 73 percent of premiums for family coverage – with no adverse tax consequences to either the employer or employee.12 It is not surprising that 77 percent of Americans are pleased with their health coverage.13

In 1983, President Ronald Reagan proposed a change to the tax law governing the exemption for health insurance, but Congress never acted on the proposal.14 In

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8 Id.; See also Joint Comm. on Taxation, Letter to Senate Finance Committee Chair Max Baucus and Ranking Member Charles Grassley, June 2, 2009.
11 Kaiser Family Found., The Uninsured: A Primer, Oct. 2009, www.kff.org/uninsured/upload/7451-05.pdf, at 1. Also, in 2008, 5% of the non-elderly received insurance through a private non-group policy, 17% were uninsured and 18% received Medicaid or other public coverage. Id.
November 2005, the President’s Advisory Panel on Federal Tax Reform recommended capping the exclusion of employment based health benefits from income, noting that doing so could reduce health spending and raise revenue for the federal government.\textsuperscript{15} President Bush proposed a cap on the exemption in his 2007 State of the Union address, but the proposal was dead on arrival in the Democratic Congress.\textsuperscript{16}

In the 2008 Democratic Primary, Presidential Candidate Hillary Clinton supported a plan to eliminate a portion of the ESI tax exemption for employees earning more than $250,000 a year, but Candidates Edwards and Obama did not propose a similar plan.\textsuperscript{17} John McCain, the 2008 Republican Presidential Candidate, proposed that the tax code be amended to eliminate the exclusion of the value of health insurance plans offered by employers from worker’s taxable income and be replaced with a deduction for health insurance that would be available to those covered under their employers’ plans as well as those who are not.\textsuperscript{18} As a candidate, President Barack Obama blasted these ideas.\textsuperscript{19}

Days after the 2008 presidential election, the Democratic Chair of the Senate Finance Committee, Senator Max Baucus (D-Mont.), issued a “Call to Action” launching the comprehensive health care reform initiative. Even though there were two Senate Committees and numerous House Committees addressing this issue, the Senate Finance Committee took the lead in attempting to craft a bipartisan and politically palatable plan. The Call to Action suggested that a cap on the ESI exclusion (based on income or the value of the benefit) could be an effective way to subsidize the cost of health insurance, among many other proposals.\textsuperscript{20} There was no mention of an excise tax on insurers.

By February 26, 2009, Obama administration officials were “suggesting” to senior aides in Congress that revenues could be raised by eliminating the ESI income tax exclusion, but did not “advocate” that option “which not only is anathema to some organized labor and business but also conflicts with Mr. Obama’s position in last fall’s presidential campaign.”\textsuperscript{21} Also in February 2009, Senators Wyden (D-Oregon) and Bennett (R-Utah) collected 9 Democrats, 4 Republicans and 1 Independent (Lieberman) as co-sponsors to

\begin{itemize}
  \item Employee Benefit Research Institute, \textit{supra} at 9.
  \item Kaiser Family Found., \textit{2008 Presidential Candidate Health Care Proposals: Side by Side Analysis}, \textit{http://www.health08.org/sidebyside.cfm}.
  \item Lori Montgomery, \textit{supra} note 16.
\end{itemize}
an alternative health care bill that converted the ESI income tax exemption to a portable
tax deduction for individuals.\(^{22}\)

In March 2009, the Wyden-Bennett coalition including both Republicans and Democrats
and the Senate Finance Committee Chair Max Baucus were advocating an income tax on
some ESI benefits.\(^{23}\) While the Administration was careful not to endorse any income
tax modification, Peter Orszag, White House Budget Director said it was an idea that
should stay on the table and “some congressional Democrats say the White House has
signaled that Obama would accept a tax on employer benefits as long as he didn’t have to
propose it himself.”\(^{24}\) As a candidate, President Obama had notoriously promised that he
would not raise taxes on families earning less than $250,000. House Democrats
continued to oppose the idea.\(^{25}\) Still, there was no mention of an excise tax on insurers.

On May 18, 2009, the options became more specific. Senate Finance Committee Chair
Baucus and Ranking Minority Member, Senator Grassley (R-Iowa), released policy
options for financing comprehensive health care reform, including five options to amend
the exclusion: (1) cap the exclusion based on the value of the policy; (2) cap the
exclusion based on the income of the employee; (3) cap the exclusion based on both the
policy value and the employee income; (4) convert the income tax exclusion to an
individual income tax deduction; or (5) convert the income tax exclusion to an income
tax credit. The policy options also explored whether to grandfather in existing plans and
also plans offered to modify or eliminate favorable income tax benefits for HSAs and
FSAs.\(^{26}\)

On May 20, 2009, the Senate Finance Committee released its more detailed Description
of Policy Options, “Financing Comprehensive Health Care Reform: Proposed Health
System Savings and Revenue Options.” In addition to the five options above, the
Committee added two more: (6) limit the exclusion to a specific grouping of taxpayers;
and (7) reformulate the income tax exclusion as a combination of a tax credit and a tax
deduction on an individual tax return. The Committee also proposed three different
indexes for the dollar amount: (1) per capita growth in the NHE (National Health
Expenditures as calculated by CMS); (2) changes in the GDP (Gross Domestic Product);
and (3) changes in the CPI (Consumer Price Index). The Committee further identified
geographic variations in medical costs as a topic to discuss.

In June, 2009, Jonathan Gruber, Ph.D., an MIT professor and arguably one of the
Democrat’s foremost health care economic experts, published a paper strongly

\(^{22}\) When this idea was presented to the Sen. Fin. Committee hearing on May 12, 2009, David Brooks,
journalist with the *New York Times* noted that the exasperation and mannerism of Chair Max Baucus
demonstrated that the idea was not going to advance. David Brooks, *Something for Nothing*, N.Y. TIMES,
\(^{24}\) Id.
\(^{25}\) Id.
advocating a cap on the exemption. Dr. Gruber called it a “win-win” situation because it raises vast revenue and also reduces the incentives for overinsurance and excessive health care spending.\footnote{Jonathan Gruber, Ph.D., A Win-Win Approach to Financing Health Care Reform, 361 NEW ENG. J. MED. 4 (July 2, 2009), available at http://content.nejm.org/cgi/reprint/361/1/4.pdf.} Dr. Gruber found three faults with the current income tax policy: (1) the foregone tax revenue is an enormous sum of money; (2) it is regressive in that higher income families get bigger tax breaks; and (3) it makes health insurance artificially inexpensive relative to other goods and services bought with taxed dollars. Additionally, Dr. Gruber found and refuted four counterarguments to a limitation on the tax exemption. First, some argue that the limitation would be administratively burdensome, but he would simply require the employer to report the amount it pays for each employee’s health insurance on his/her W-2. Second, some argue that eliminating incentives for employers to provide insurance, could cause an increase in the number of uninsured, but Dr. Gruber cites the availability of universal health insurance plans as an alternative to employer-based health insurance. Third, removal of the exclusion would result in a tax increase for middle class families as well as the wealthy, but Dr. Gruber proposed a structure to cap the number of middle class families who would be affected. Finally, Dr. Gruber acknowledged that there would be some high cost groups (geographic, age) that would need cap adjustments in order to make the cap equitable.\footnote{Id.}

In a July 4, 2009 article, the Boston Globe reported that capping the ESI tax exemption at $13,500 a year (the price of a basic family plan offered to members of Congress) would raise $420 billion over the next decade, but that the Senate Finance Committee was considering a higher cap of $17,000 for families. The article cited support from the conservative Heritage Foundation as well as the Democratic consultant Dr. Gruber, but acknowledged the political difficulty nonetheless.\footnote{Lisa Wangsness, Healthcare overhaul could limit tax breaks on benefits, BOSTON GLOBE, (July 4, 2009), available at http://www.boston.com/news/nation/washington/articles/2009/07/04/healthcare_overhaul_could_limit_tax_breaks_on_benefits/?page+2.}

The Emergence of the Cadillac Plan Tax

As the Senate Finance Committee engaged in its summer “off the record” discussions, a consensus was growing for a modification to the ESI tax exemption, but grumblings about the impact on workers, unions and businesses persisted.\footnote{Id.} Senator John Kerry (D-Mass.) claims responsibility for introducing this new tax design in July 2009.\footnote{Website of Sen. John Kerry, http://kerry.senate.gov/.} The Cadillac Plan emerged as the political fix – an excise tax on (the evil) “insurers” based on (the evil) “high cost or excessive insurance plans.”

Shortly thereafter, the Obama Administration began to make reference to “Cadillac Plans” as expensive, all encompassing healthcare plans for wealthy employees, such as
the Goldman Sachs executives who indulged a variety of well-known excesses. David Axelrod, senior advisor to the President was asked about the President’s position on the excise tax and said the President found it “an intriguing idea to put an excise tax on high-end health care policies like the ones that the executives at Goldman Sachs have, the $40,000 policies.” Chairman Baucus and House leaders were both said to be considering this new proposal.

As the plan progressed from the Chairman’s Mark (CM) to the Modified Chairman’s Mark (MCM), to the Senate Finance Committee’s bill (S. 1796) to the Senate bill (H.R. 3590) to the President’s informal negotiations with labor union leaders (UL) to the President’s Proposal in February 2010 (PP), the ability to positively impact revenues dramatically decreased. Anticipated additional revenues over ten years decreased from $215 billion in the Chairman’s Mark to $90 billion after negotiations with union leaders and then to almost nothing under the President’s Proposal to delay the tax until 2018. Specifically, the threshold amounts climbed from $21,000 (CM, MCM, S. 1796) to $23,000 (H.R 3590) to $24,000 (UL), to $27,500 (PP) for family plans and from $8,000 (CM) to $8,500 (H.R. 3590) to $8,900 (UL) to $10,200 (PP) for individual plans. Other increases to the threshold amounts included: a 20 percent increase for the 17 highest cost states (all proposals); and increases of $1,800 (MCM) for individuals and of $5,000 (MCM) for families for retired individuals over age 55 as well as for employees in high risk jobs (law enforcement, firefighters, members of rescue squads and ambulance crews, individuals in construction, mining, agriculture [but not food processing], forestry, and fishing). The Manager’s Amendment to S. 1796 specifically added Longshore Workers to the high risk professions. The union negotiations with the President delayed the effective date of the plan until 2018 for union members, increased thresholds for women and older workers and eliminated vision and dental insurance from the aggregated threshold calculation. The President’s Proposal extended these union concessions to all workers and delayed the entire implementation of the now emasculated plan until 2018.

Conclusion

In an attempt to reap the benefits of a modification to the ESI tax exemption (which had enjoyed bipartisan support) and to avoid the political negatives associated with a direct income tax increase on the middle class, the Senate lunged desperately toward the

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34 Id.


Cadillac Plan tax. Advocates initially over-hyped the plan. They claimed it, like an amendment to the ESI exemption, would raise significant revenue and bend the cost curve, but unlike an amendment to the ESI exemption it would not affect the middle class. The current plan neither raises revenues nor bends the cost curve and ultimately would affect the middle class. With eight years before the tax is set to be imposed, hopefully our nation will engage in a forthright, factual discussion of the ESI tax exemption and Congress will rethink the tax structure and amend the legislation to offer a more sensible solution.

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