What is the Cadillac tax?

Employer-sponsored health benefits whose value exceeds legally specified thresholds will be subject to a 40 percent excise tax, starting in 2020. The so-called "Cadillac tax" will be levied on insurance companies, but the burden will likely fall on workers. The tax will effectively limit the tax preference for employer-sponsored health insurance.

TAX ON HIGH-COST HEALTH PLANS STARTING IN 2020

Under the Affordable Care Act, employer-sponsored health benefits whose value exceeds specified thresholds will be subject to an excise tax starting in 2020. This "Cadillac tax" will equal 40 percent of the value of health benefits exceeding thresholds projected to be $10,800 for single coverage and $29,050 for family coverage in 2020. The thresholds will be indexed to growth in the consumer price index in subsequent years. Thresholds will be higher for plans with more-expensive than-average demographics, retirees ages 55 to 64, and workers in high-risk professions. The Cadillac tax will apply not only to employers' and employees' contributions to health insurance premiums, but also to health saving account, health reimbursement arrangement, and medical flexible spending account contributions.

WORKERS BEAR THE BURDEN

The tax will be levied on insurance companies, but the burden will likely be passed on to workers in the form of lower wages. Some employers will avoid the tax by switching to less expensive health plans; this will translate into higher wages but also higher income and payroll taxes. In fact, the Joint Committee on Taxation and the Congressional Budget Office predict that three-quarters of the revenue raised by the Cadillac tax will be through the indirect channel of higher income and payroll taxes, rather than through excise taxes collected from insurers. Simulations suggest the excise tax will have the largest impact on families in the middle and fourth income quintiles (Mermin and Toder 2015).

EFFECTIVELY LIMITS THE ESI EXCLUSION

Employer-provided health benefits are excluded from taxable income, reducing income and payroll tax revenue by $250 billion in 2015. Even if one ignores the revenue losses, there are other undesirable aspects of the exclusion. The exclusion for employer-sponsored health insurance (ESI) is poorly targeted, as it is worth more to taxpayers in higher brackets who would be more likely to purchase insurance in the first place. Additionally, the ESI exclusions' open-ended nature may contribute to faster health care cost growth. For these reasons, analysts have often suggested limiting the ESI exclusion by including the value of health benefits beyond a certain threshold in taxable income (Congressional Budget Office 2013).

While the Cadillac tax plan is not a direct limit, it effectively curtails the ESI exclusion. If employers avoid the excise tax by shifting compensation from health benefits to taxable wages, the ultimate impact will be identical to an exclusion limit. In both cases, health benefits that exceeded the thresholds before introduction of the Cadillac tax would become subject to income and payroll taxes. If employers continue to offer high cost health plans, the impact will be similar to an exclusion limit—though less progressive. Excess benefits would be taxed at a 40 percent rate rather than an individual worker's marginal tax rate.[1]

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[1] After accounting for income and payroll tax offsets, the effective excise tax rate is ultimately lower than 0.4 and in fact declines with income.

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