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Kerry's Excise Tax on "Gold-Plated" Health Insurance Policies

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The latest entry in the U.S. Senate's "Find the Health Care Compromise" contest comes from Senator John Kerry (D–MA).

Kerry has suggested including in health legislation a new excise tax on "gold-plated" or "Cadillac" health insurance policies. He offered this idea as an alternative to proposals that would cap the long-standing tax exclusion for employer-provided health insurance. But it is not the right way to go.

The Need for Tax Reform. Before considering Senator Kerry's proposed substitute, it is important to note that capping the tax exclusion itself has merit only if it is a revenue-neutral reform of health care tax policy—not as a way of increasing taxes to pay for new or expanded health spending programs.[1]

That said, the basic idea of setting a limit on how much income workers can get tax-free in the form of health insurance benefits does have bipartisan support. But it has also drawn opposition from unions who have negotiated generous tax-free health insurance coverage for their members.

Proponents of setting a cap on the tax exclusion point out that Congress has set limits on almost all other tax-free fringe benefits. For example, under current tax law, only the premiums on the first $50,000 of a worker's group term life insurance policy are tax-free.[2] Similarly, no more than $5,000 per year per family can be set aside on a pre-tax basis to pay for daycare for a worker's dependents.[3] There are also limits on tax-free contributions to 401(k) plans.

Of course, employers can always provide additional life insurance coverage or dependent daycare for their workers. It is just that tax law requires that the value of any such extra employer spending be treated as taxable income to the workers receiving those fringe benefits—the same as if it had been paid to them as cash wages.

Setting a limit, or a cap, in the income tax code on tax-free employer-provided health benefits would work the same way. An employer could still provide its workers with a plan that costs more than the cap, but the extra spending would be appear on the employees' W-2 forms as taxable income.

Of course, once those employees realize that they are going to be taxed on the money anyway, they might decide that they would rather spend it on something other than extra health insurance. That is why the idea of capping the tax exclusion has long appealed to serious health care reformers across the political spectrum as a way of boosting cash compensation as well as increasing consumer cost consciousness when it comes to the value of health benefits and the medical care that they buy.

The Kerry Proposal. Senator Kerry's proposal of an excise tax is not the same as reforming the tax exclusion. Faced with union opposition to capping the tax exclusion Senator Kerry suggests that Con-

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gress instead impose a new excise tax on health insurance policies that exceed a specific amount.

As with other "compromise" ideas now floating around Congress, the specifics behind the sound bite have yet to be spelled out. However, beyond setting the dollar amount for coverage above which the excise tax would apply, another issue matters: Will the tax be applied only to insurance policies sold by commercial insurers, or will it also apply to self-insured plans?

This question matters because the more expensive health insurance plans are not likely to be purchased from commercial insurers either as individual policies or as group policies for workers in small businesses. Rather, they are likely to be plans covering executives in large companies or unionized workers in the private and public (state and local government) sectors—the same people who tend to also have the most generous pension plans, for much the same reasons.

Currently, about 45 percent of workers with employer-sponsored health insurance are in "fully insured" plans—that is, plans purchased by employers from commercial health insurers. The other 55 percent get their coverage through self-insured plans designed and managed by a single employer, a group of employers, or a union where the plan is funded through contributions from employers whose workers belong to the union.[4]

However, the distribution of the two plan types is highly skewed based on firm size. In 2008, 88 percent of workers in firms with three to 199 employees were in fully insured plans, while 89 percent of workers employed in firms with 5,000 or more employees were in self-insured plans.[5]

Targeting Employer and Union Plans. Thus, the more expensive health plans are likely to be self-insured plans. While it is true that self-insured plans often contract with commercial health insurers for administrative tasks, in most cases the insurer just gets paid an agreed-upon, per-unit fee for the services it provides. Deciding the benefit package—and thus what the plan will cost—is entirely up to the employer.

Consequently, an excise tax on "gold-plated" or "Cadillac" health insurance plans that is imposed only on fully insured plans would likely have very little effect. Commercial insurers probably sell few policies today that would become subject to the tax, and they would likely cease offering any such policies as soon as the tax takes effect—on the reasonable presumption that what little customer demand currently exists would disappear.

Furthermore, applying the excise tax to the "administrative services only" (ASO) business of commercial insurers would also have little effect. To avoid the tax, commercial insurers would simply refuse to enter into ASO contracts with self-insured plans whose benefit costs were above the tax threshold. At the same time, the employer or union sponsors of those self-insured plans could also avoid the tax—without changing the benefits or costs of their plans—simply by moving the claims processing and other administrative functions in-house.

Thus, in order for an excise tax on "gold-plated" or "Cadillac" health insurance plans to have more than a negligible effect, Congress would actually have to apply the tax directly to the employers and unions that sponsor self-insured plans whose benefit costs exceed the tax threshold.

The Wrong Route. Senator Kerry's "compromise" proposal is a political device to hide a tax on workers of all incomes rather than to reform the tax treatment of health care. Applying an excise tax to all "gold-plated" or "Cadillac" health insurance plans, both fully insured and self-insured, would

1. See Stuart M. Butler, "How to Design a Tax Cap in Health Care Reform," Heritage Foundation *WebMemo* No. 2517, July 1, 2009, at *http://www.heritage.org/Research/HealthCare/wm2517.cfm*.
2. 26 U.S. Code § 79(a).
3. 26 U.S. Code § 129(a)(2)A.
4. Employee Benefit Research Institute, "Health Plan Differences: Fully-Insured vs. Self-Insured," February 11, 2009, at *http://www.ebri.org/pdf/FFE114.11Feb09.Final.pdf* (July 31, 2009).
5. *Ibid.*

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not have the same effects as capping the tax exclusion and providing tax relief in a revenue-neutral way to Americans who cannot afford coverage.

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