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## **Pay or Play? How Health Care Reform Changes the Game for Employers**

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Will the Patient Protection and Affordable Care Act (PPACA) induce employers to terminate their health insurance coverage for employees? Numerous business articles, editorials, and op-eds have made that prediction. The analysis below, however, shows that employers are more likely to increase employee premiums than terminate coverage entirely. For employees who drop coverage to avoid the cost increases, the debate may be academic. Still, for other employees, and for employers making their business plans, the distinction is quite important.

First, let's look at the case for dropping coverage:

- Starting in 2014, employees will be able to purchase coverage on an exchange, with no exclusion for preexisting conditions.
- The PPACA is driving health coverage costs up for employers.
- The penalty for not offering coverage (\$2,000 per full-time employee) is less than the cost of providing coverage.
- Why not just let employees purchase their own coverage on an exchange?

This simplistic analysis fails to address the reasons that employers today offer health coverage, despite the fact that currently there is *no penalty* for failing to offer such coverage. Employers do this for a variety of reasons, but one stands out: it is often *less expensive* to provide health coverage than to pay the higher salary that employees would require of an employer that offers no health coverage. The reasons for this are explained below.

In addition, starting in 2014, the penalty to the employer will be very heavy if the employer fails to offer coverage, but the penalty will be very mild if the employer offers coverage at a high premium rate to the employee.

### **I Will Work for Food (and Health Coverage)**

When I go to work, I expect to get paid money, but my ultimate goal is to exchange that money for *stuff*: food, shelter, clothing, cars, and yes, medical care. However, instead of using money to purchase medical care, I use the money to buy coverage through my firm's group policy, and then the insurance company pays my doctor and other medical care providers.

Sure, I could just get money and pay for my health care myself, but I prefer to use insurance, and I prefer to get my insurance through work. So, if my firm didn't offer health coverage, then I would go work somewhere else unless my employer paid a higher salary. How

much higher? More than the cost to the employer of the health coverage. Why is this? There are several reasons.

- **Paying for medical care is more expensive for an individual than for an insurance company.** Insurers negotiate very deep discounts, and medical providers dramatically overcharge uninsured individuals (if they are willing to care for them at all).
- **Money paid directly to providers (doctors, hospitals, pharmacies, etc.) is generally not deductible.** However, if you pay for coverage through a pretax premium plan at work, that money not only escapes income tax, but FICA tax as well. The employer also saves the FICA tax, which generates savings to employers who offer health coverage.
- Many employees have an **aversion to risk of financial loss** associated with major illness.
- **Individually purchased insurance costs much more than employer-provided coverage** because of anti-selection. Generally, only very sick people purchase individual insurance, whereas individuals covered by employer-provided coverage tend to be a more representative cross-section of the population. In addition, advertising, selling, billing, and general administration costs are much higher for insurers that sell individual insurance than for group policies.

As you can see, the factors above are not dependent on the employer subsidizing the cost of health coverage. Even if the employer passed 100 percent of the cost of health coverage on to employees in the form of pretax employee premiums, there would still be a substantial advantage to the employee in obtaining health coverage (over simply paying for medical care) and a substantial advantage in doing so through work, rather than on the individual market.

Most employers also find it advantageous to subsidize health coverage. That is, the amount of the pretax employee premium is much less than the actual cost of coverage, with the employer paying the difference. Why would this be?

- It is usually impossible to pass 100 percent of the cost of coverage on to the employee. This is because as the employee premium increases, the younger and healthier employees tend to drop coverage. The remaining employees have a higher average cost, which if passed through, will cause more young, healthy employees to drop coverage. Eventually, you are likely to end up with a death spiral of increasing premiums and decreasing numbers of covered employees.
- Many employers want their employees to have coverage, even if the employee doesn't value it very much. This may be for moral reasons, a sense of community responsibility, or for positive public relations. However, even absent a sense of altruism, the employer may simply want to avoid absenteeism and the impact on morale associated with long-term employees who become sick and are unable to pay their medical bills.

## PPACA Subsidies and Penalties

Even before the PPACA, increases in the cost of health insurance coverage have been straining employers' budgets. The PPACA is pushing costs up in numerous ways. Restrictions on lifetime limits, annual limits, copayments, and deductibles all push up costs, as do many other provisions of the PPACA.

However, the mix of subsidies and penalties in the PPACA actually strengthens the case for offering health coverage but may also support the case for shifting costs to employees by increasing the pretax employee premium. Before delving into the analysis, however, it is necessary to understand four key facets of the PPACA.

First, **exchange coverage** will be available as an alternative to employer coverage. Obviously, the exchanges do not exist yet, so much about them is unknown. And, they will vary somewhat from state to state. However, certain factors are known or seem to be unavoidable. The exchanges will offer individual health insurance coverage without exclusion for preexisting conditions, and for some employees, that coverage will be heavily subsidized.

However, for employees whose family income exceeds four times the poverty level, there is no subsidy. So, if a single employee has an income of about \$40,000, or an employee with a family of four has a family income of about \$88,000, the cost of coverage on the exchange will have to be fully paid for by the employee. The subsidy available is based on income, so employees with incomes below, but relatively close to the threshold, will have only a modest subsidy. The exchange coverage is likely to be very expensive before the subsidy, because it will be individual insurance and will suffer from heavy anti-selection (that is, more sick people purchasing the coverage).

Second, there is the badly misnamed "**individual mandate**." The mandate is actually a rather modest penalty under Section 5000A of the Internal Revenue Code for individuals who do not have health insurance coverage. Many low-income individuals and families will be exempt from the penalty. For those who are not, the full penalty (once it is fully phased in, in 2016) will be \$695 or if greater, 2.5 percent of income above a threshold.

The threshold is about \$10,000 for an individual and about \$19,000 for a married couple. So, for the single employee with income of \$40,000, the penalty would be about \$750. Since exchange coverage will not be subsidized for this individual, the cost of coverage will certainly be much more than \$750. Therefore, the penalty can hardly be called a "mandate," and many employees (particularly the young and healthy ones) will be willing to forgo insurance and pay the penalty. Even at lower income levels, the penalty will be smaller than the cost of purchasing health insurance on an exchange, even with the subsidy.

Third, there is the penalty in Section 4980H(a) (which we call the "**sledgehammer tax**"). The sledgehammer tax applies to a "large employer" (more than 50 full-time employees or full-time equivalents) that does not offer health insurance coverage to all of its full-time employees. If even *one* employee purchases insurance on the exchange and receives a federal subsidy, the

employer is hit with the sledgehammer. The sledgehammer tax is \$2,000 times the number of full-time employees, with the first 30 employees not counted. So, for Company X that has 10,030 employees, the sledgehammer tax is \$20 million, even if only one employee has subsidized exchange coverage.

Finally, there is the penalty in Section 4980H(b) (the “**tack-hammer tax**”). This applies if the employer offers coverage but it is too expensive, and an employee purchases subsidized coverage on an exchange instead. The tack-hammer tax is \$3,000 per year for each employee who actually purchases subsidized exchange coverage. The statute provides that it cannot be greater than the sledgehammer tax, and you don’t pay both – it’s one or the other. So, consider the case of Company X, which has 10,030 employees but now offers coverage (at a high employee premium) to all full-time employees. If 1,000 of those employees purchase subsidized exchange coverage, the tack-hammer tax would be \$3 million, as compared with the \$20 million sledgehammer tax that would apply if coverage were not offered by Company X.

### **The Exchanges Will Not Be Sufficient for High-Value Employees**

Nearly all high-value employees have health insurance coverage and will insist on having it, one way or another. As noted above, the exchanges will be an individual market and as such, subject to the individual selling and administration costs and anti-selection that is currently inherent in the individual market. In addition, the exchange policies will have to cover preexisting conditions, aggravating anti-selection, and the premium on an exchange policy does not escape FICA or income taxes. So, the after-tax cost of exchange coverage will be prohibitive compared with employer-sponsored coverage, even if the employer passes nearly the entire cost on to the employee.

When you add in the advantage of income tax exemption and FICA tax exemption for the employee’s pretax premium with employer coverage and the additional FICA tax savings for the employer, the case for employer coverage with respect to high-value employees is compelling. The employer that chooses to eliminate coverage for these employees will have to pay much higher salaries to be competitive, on an after-tax basis, with employers that continue to maintain health insurance – the required salary differential will be much more than the cost of maintaining a health insurance plan.

### **For Less Highly Paid Employees, the Tack-Hammer Tax Is Better Than the Sledgehammer Tax**

The sledgehammer tax is \$2,000 per employee, and the tack-hammer tax is \$3,000 per employee. So, why isn’t the tack-hammer penalty worse? One reason is that the tack-hammer penalty is limited so that it cannot, by definition, be more than the sledgehammer penalty. (You pay only one or the other, not both.) However, the more important reason is that the sledgehammer tax counts all full-time employees, even if they have employer coverage, while the tack-hammer tax applies only to those who purchase coverage on an exchange and receive a subsidy. Assuming that the employer offers coverage to all full-time employees, even if the

employee pretax premium covers the full cost (or nearly the full cost), several groups of employees will not be counted toward the tack-hammer penalty.

**Employees who don't count toward the tack-hammer penalty include:**

- Employees who purchase the employer coverage.
- Employees whose family income exceeds the subsidy threshold (currently about \$40,000 for a single individual and about \$88,000 for a family of four). The family income would include the spouse's income.
- Employees who obtain coverage under their spouse's employer coverage.
- Employees who obtain coverage through their parents' employer (generally, through age 26).
- Employees who do not want to (or cannot afford to) pay the exchange premium, which even after the subsidy, will be greater than the individual mandate tax.
- Employees who simply do not value health insurance coverage and therefore do not purchase it on an exchange.
- Employees who are eligible for Medicare or Medicaid.
- Employees who remain covered under a prior employer's retiree medical plan (which would include many former government workers, as well as a few in the private sector).

**Should Company X Terminate Its Health Insurance Plan?**

Let's assume that Company X, seeing its medical costs going up, can no longer afford the cost of its plan. It is considering terminating coverage entirely in 2014, on the theory that employees can purchase coverage on an exchange.

There are any number of alternatives to terminating the plan. However, it is only necessary to identify one alternative that is better than termination in order to discard the choice of terminating the plan. From that point, the question would be: What is the optimal solution?

Finding the optimal solution is a data-intensive process that goes beyond the scope of this article. But finding one solution that is clearly better than terminating the plan is pretty easy. That alternative is to provide coverage with an employee pretax premium that is only slightly subsidized by the employer. Let's say the employer's subsidy is \$2,000 per employee, and the total cost of coverage for the average employee is \$7,000 per year (blending individual and family coverage). Finally, we'll make the rather conservative assumption that unsubsidized exchange coverage will cost only \$1,000 more than the employer coverage (that is, an average cost of \$8,000). Here is a comparison of the two alternatives.

First, we start with the impact on the employee. Company X has 10,030 employees. About 3,000 of these employees are highly skilled and paid and will purchase medical coverage no matter the cost. For these employees, the two alternatives play out as follows:

Company X – Impact on High-Value Employees	No Plan / Employee Uses Exchange	Employer Coverage / \$2,000 Subsidy
Cost of coverage per employee	\$8,000	\$7,000
Cost paid by employer	0	2,000
Cost paid by employee	8,000	5,000
FICA tax savings to employee	0	(383)
Income tax savings (average fed + state rate 30%)	0	(1,500)
Net cost to employee	8,000	3,117
Salary increase with tax gross up to equalize employee *	12,830	4,999
<b>Additional Cost to Employer</b>		
Additional cost of salary gross up	12,830	4,999
Additional employer FICA tax on gross up	981	382
FICA savings to employer from pretax premium	0	(383)
Cost of employer subsidy of coverage	0	2,000
Total cost to employer per employee	13,811	7,764
Additional cost of terminating plan over increasing employee premium	6,047	
Additional cost for 3,000 employees (before corporate income tax)	\$ 18,141,000	
Additional cost for 3,000 employees (after effect of corporate income tax of 35%)	\$ 11,791,650	

\*Note that the gross up is based on an average combined federal, state, and FICA tax rate of 37.65%. The gross up would be computed by dividing by 0.6235 (or one minus 37.65%).

Next, we need to look at the impact of the sledgehammer tax and the tack-hammer tax on each of these scenarios. The numbers below are reasonable estimates for a typical employer:

Company X – Comparison of Penalties	No Plan / Sledgehammer Tax	\$2,000 Subsidy Tack-hammer Tax
Total employees	10,030	10,030
Who get employer coverage	-	(3,000)
Who get coverage through spouse or parent, Medicare, Medicaid, or a prior employer	-	(2,000)
Who purchase unsubsidized exchange coverage	-	(200)
Who choose not to purchase any coverage	-	(3,000)

Reduction by 30 – Sledgehammer only	(30)	-
Net number of employees subject to tax (for tack-hammer, the number with subsidized exchange coverage)	10,000	1,830
Tax rate	\$ 2,000	\$ 3,000
Total nondeductible tax	\$ 20,000,000	\$5,490,000

Company X – Comparison of Total Costs	No Plan	\$2,000 Subsidy
Additional after-tax cost for high-value employees	\$ 11,791,650	-
Penalty (sledgehammer or tack-hammer)	\$ 20,000,000	\$ 5,490,000
Total cost	\$ 31,791,650	\$ 5,490,000

The analysis above suggests that for Company X, which is considering terminating its health plan, the option of merely raising the employee premium carries a \$26 million advantage. One may quibble slightly about the precise numbers, but the discrepancy is so large that no reasonable scenario is going to arrive at a different overall conclusion: terminating the plan entirely is not the most cost-effective option. This is not to say that increasing the employee premium is necessarily the best option for Company X, or that the suggested \$5,000 average premium is the optimal solution. Rather, the analysis above is sufficient to reject the idea of terminating the plan and to allow Company X to proceed to the more complex challenge of optimizing the result.

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