Rethinking Retiree Drug Coverage

Health Care Reform’s Impact on Medicare Part D – April 8, 2010

There are many changes employers must address due to the landmark health care legislation enacted last month. While much of the details are still being sorted out, there are certain issues related to retiree drug coverage that employers need to carefully consider, with some requiring immediate action.

Overview

There are multiple changes included in the recently enacted health care reform legislation that impact retiree health benefits, in particular Medicare Part D drug coverage. Employers should carefully consider these changes and determine what retiree drug coverage now best aligns with their organization’s goals and objectives.

What is Happening?

- When enacted in 2003, Medicare Part D prescription drug coverage included a ‘coverage gap’ (often referred to as the donut hole) when annual cost of drugs reached a certain level, currently $2,830.
- Employers were encouraged to continue providing prescription drug coverage to retirees through tax-free subsidies and the ability to deduct the entire amount they paid for drug coverage, including the amount reimbursed through the subsidy.
- The newly passed health care reform bill phases out the coverage gap under Medicare Part D.
- The tax treatment of the prescription drug coverage will change beginning 2013. Currently, employers who receive a subsidy under Medicare Part D can deduct the full amount of benefits paid. Under the new law, employers can only deduct the benefits paid minus the subsidy, thus creating a new tax liability that needs to be reflected immediately on their financials.

What Does This Mean for Employers?

- Due to the change in tax rules, employers’ cost of providing prescription drug coverage increases. This will average $200 per year per retiree, assuming an average of $2,500 in annual coverage. For a company with 10,000 retirees, this equates to an estimated increase of $2 million per year.
- While the tax rules remain unchanged until 2013, US GAAP requires that the reduction in deferred tax assets be recognized beginning with the first quarter of 2010 for employers with calendar year tax years.
- The elimination of the coverage gap and the increased cost due to the change in tax rules makes employer-provided coverage less attractive than when Medicare part D was originally introduced.

What Should Employers Do?

- In the short-term, seek guidance from your tax counsel to assess the impact of the change in tax deductions on your financial statements. This may require actuarial calculations to best determine the impact.
- Next, evaluate your retiree medical design options, including elimination of prescription drug coverage or moving to a group Part D program.
• Continue to monitor regulatory changes and their impact on coverage and costs.

**What Positions Are Others Taking?**

• Many employers have already announced significant one-time charges against earnings for this year due to the change in the tax rules.

• Audit firms have confirmed that these charges are required to be reflected in the quarter the law changed, thus impacting first quarter earnings for companies with calendar year tax years.

• Employers and their associations are pushing for the tax change to be repealed, arguing that it will further compel employers to cease their retiree medical programs. In a study commissioned by the American Benefits Council, it was estimated that between 1.5 and 2 million retirees now face a change in drug coverage.

• The White House defends the provision, however, stating that the change was deliberate and intended to remove a tax loophole.

• Meanwhile, the House Committee on Energy and Commerce has scheduled a hearing later this month, summoning the CEOs of some of the larger companies impacted by the change, to discuss the provision and the resulting charges to earnings. The committee chair is challenging the magnitude of the charges being reported and the projected impact on the continuation of employer-provided coverage.