



Wayne Watts  
Senior Executive VP & General Counsel  
Legal Department

**Confidential/Highly Sensitive and  
Proprietary Business Information**

April 12, 2010

The Honorable Henry A. Waxman  
Committee on Energy and Commerce  
The Honorable Bart Stupak  
Subcommittee on Oversight and Investigations  
United States House of Representatives  
2125 Rayburn House Office Building  
Washington, D.C. 20515-6115

Dear Chairmen Waxman and Stupak:

I am responding to your recent letter to our Chairman and Chief Executive Officer, Randall Stephenson, regarding AT&T's Form 8-K Current Report, filed with the United States Securities and Exchange Commission (SEC) on March 26, 2010 (8-K filing).

The information we disclosed in the 8-K filing reflects the one-time financial consequences to the company triggered by a specific provision of the Patient Protection and Affordable Care Act, as amended by the Health Care and Education Reconciliation Act of 2010 (collectively referred to herein as the PPAC), relating to the non-deductibility of certain of the company's retiree prescription drug costs for which it receives a subsidy. The charge reflected in the 8-K filing was calculated based on clear, unambiguous and generally accepted accounting principles. Under the rules of the SEC and New York Stock Exchange (NYSE), we filed our 8-K in a timely manner as required to inform our shareholders; permit company personnel to discuss these impacts with financial analysts; and update prospectuses both for the public sale of AT&T debt and equity and in connection with AT&T employee benefit plans. Thus, certainly as it pertains to AT&T, White House Senior Advisor Valerie Jarrett was exactly right in saying that, "the companies who are reporting this charge against their net earnings aren't pushing back, they're following the law."<sup>1</sup>

While we continue to work with your staff on the details of the document request contained in your letter, we offer on a highly confidential basis the following materials for your preliminary consideration. These documents have been, for purposes of identification and reference, consecutively numbered from AT&T-EC-00001 through AT&T-EC-00027.

- AT&T Policy Review documents from December 2009 and February 2010 that outline AT&T's assessment of the impacts to the company of, respectively, the healthcare reform

<sup>1</sup> John McCormick, "Jarrett Says AT&T, Deere Not Undermining Health Law (Update 2)," (March 31, 2010) available at <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=awjWaE1BQil1s> (last accessed April 2, 2010).

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bill then under consideration by the full Senate and President Obama's February 22, 2010, proposed framework for reform. (Attachment 1: AT&T-EC-00001 – AT&T-EC-00003)

- March 25, 2010, presentation to the AT&T Board of Directors by the company's Senior Executive Vice President for Human Resources regarding the just-enacted PPAC. (Attachment 2: AT&T-EC-00004 – AT&T-EC-00009)
- November 2, 2009, letter from the American Benefits Council and the AFL-CIO to Speaker Nancy Pelosi, and a December 15, 2009, letter from the Communication Workers of America (CWA), the International Brotherhood of Electrical Workers (IBEW), AT&T and Verizon to Senator Harry Reid. Both letters explain the potential consequences of the provisions of the PPAC, which were at the time still under consideration by the Senate and ultimately enacted by the legislation, that would eliminate the deductibility of certain retiree prescription drug costs for which companies receive a subsidy (known as the Retiree Drug Subsidy or "RDS"), resulting in increased tax liabilities. These provisions, once enacted, triggered AT&T's 8-K filing.<sup>2</sup> (Attachment 3: AT&T-EC-00010 – AT&T-EC-00013)
- Three third party analyses of the accounting and other implications of the change in the tax treatment for the RDS.<sup>3</sup> (Attachment 4: AT&T-EC-00014 – AT&T-EC-00026)
- Worksheet that reflects the manner in which AT&T calculated the charge ultimately reported in the 8-K filing. (Attachment 5: AT&T-EC-00027)

We would welcome an opportunity to discuss these documents and the substance behind them with you or your staff. We hope that these documents and our discussions will potentially obviate the need for a broader inquiry into these matters or AT&T's appearance at a congressional hearing.

As the largest employer of full-time unionized employees in the country, as well as the only national wireless company that is unionized, we provide our employees, retirees and their families comprehensive and generous health benefits. In 2009, AT&T provided almost 1.2 million employees, retirees, and their respective dependents healthcare benefits, spending over \$2.3 billion on health and welfare benefits for retirees and their families alone, over 90% of which was for healthcare. This is in addition to the billions of dollars spent on health care coverage for our active employees and their dependents. For this reason, AT&T continues its comprehensive assessment of the PPAC, its potential short and long term benefits and costs, and

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<sup>2</sup> Unlike other documents that we provide at this time, we do not consider these letters to be confidential, as they are in the public domain.

<sup>3</sup> Unlike other documents that we provide at this time, we do not consider these analyses to be confidential, as they are in the public domain.

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its ultimate implications for our employees, retirees and the way we design our benefit plans. Should the structural reforms intended to reduce the costs of delivering healthcare under the PPAC ultimately prove successful over time, self-insured companies like AT&T would likely benefit from such reduced costs.

Finally, as our counsel have discussed with Committee staff, many of the documents being provided today contain confidential information, including highly sensitive and proprietary business information, and such documents have been marked accordingly. Many such documents contain material non-public information, the disclosure of which to any third parties would have important business and other implications. Accordingly, at this time we reiterate the request made by our counsel that such documents be kept confidential by the Committee and its staff. We would also ask that Committee staff provide our counsel with notice and an opportunity to be heard before the Committee, notwithstanding our request that such documents be kept confidential, discloses any information from such documents to any third parties. Production of these documents is not intended to be a waiver of the attorney-client, attorney work product, or any other applicable privileges.

Very truly yours,



Wayne Watts  
Sr. Executive Vice President  
and General Counsel

cc: The Hon. Joe Barton, Ranking Member, House Energy and Commerce  
Committee  
The Hon. Michael Burgess, Ranking Member, Subcommittee on Oversight and  
Investigations

## Health Care Reform Analysis AT&T Policy Review

### LEGISLATIVE BACKGROUND

On November 19th, the Senate released the legislative language of H.R. 3950, Patient Protection and Affordable Care Act. On December 19<sup>th</sup>, a manager's amendment to H.R. 3950 was released. The Senate is scheduled to vote on the managers amendment December 24<sup>th</sup>. If approved, the bill moves to conference to reconcile the Senate version with the House version. When reconciled, the bill then would be sent to the President for signature. The President has set the time frame for his signature to be prior to the State of the Union address in mid to late January.

### MAJOR PROVISIONS OF SENATE BILL RELATIVE TO AT&T POLICY

Provision	Timing	Estimated 10 yr. Cost to AT&T
<b>Medicare Part D Subsidy</b> <ul style="list-style-type: none"> <li>• Tax subsidy AT&amp;T receives on prescription drugs for Medicare retirees</li> <li>• One time expense impact is based on assuming the reduction in the deferred tax asset is immediately recognized through the income statement</li> </ul>	2011	\$400-640M: \$1.3B one time expense impact
<b>Excise Tax</b> <ul style="list-style-type: none"> <li>• Tax company plans with costs above benchmark levels</li> </ul>	2013	\$10-125M
<b>Medicare Payment Reforms</b> <ul style="list-style-type: none"> <li>• Reduces Medicare reimbursements, which helps AT&amp;T</li> <li>• Reduces Medicare Advantage (HMO) subsidies</li> <li>• Shifts expenses from Medicare to private / individual plans</li> </ul>	Various from 2010 - 2014	\$10-200M
<b>Penalty for Not Offering Coverage</b> <ul style="list-style-type: none"> <li>• Employer pays subsidy to government if no coverage is provided or it is deemed unaffordable</li> </ul>	2014	\$170-255M
<b>Free Choice Voucher</b> <ul style="list-style-type: none"> <li>• Employer must provide employees a voucher for coverage if they make below 400% of the FPL and pay 8-9.8% of gross income for medical coverage</li> </ul>	2014	\$0

## Health Care Reform Analysis AT&T Policy Review – Obama Plan

### OBAMA PLAN SUMMARY

On February 22, 2010, President Obama released his proposal for health care reform. Obama's plan is the Senate bill with some incremental changes. The key changes from AT&T's perspective are summarized below:

- **Excise Tax:** Obama's plan softened the excise tax provision by increasing thresholds 20% from \$8.5K to \$10.2K for individuals and from \$23K to \$27.5K for families. In addition he removed dental and vision expenses and deferred implementation until 2018. Based on initial estimates, none of our plans would be taxed until 2020.
- **Medicare Part D Coverage:** The Obama plan closes the Medicare Part D coverage gap, also known as the donut hole, through a phased in approach that completes in 2020. This increases the value of the government's offering, which we must match to receive the Medicare Part D subsidy of approximately \$100M annually.
- **Penalty for Not Offering Affordable Coverage:** The Obama plan reduces the penalty for unaffordable coverage from \$3,000 to \$2,000 per person, and the plan allows for a 90-day waiting period for new hires. If we maintain our six month waiting period, AT&T would be penalized approximately \$11M to \$17M annually.

Obama's plan lowers premiums for lower income families. To fund this expanded coverage and offset revenue losses from the excise tax changes, the Obama plan:

- reduces Medicare benefits
- increases fees on the Rx industry from \$23B to \$33B over ten years
- taxes individuals who can afford but don't purchase coverage
- assesses penalties on companies that do provide coverage or offer unaffordable coverage
- targets reductions in waste and fraud, and
- expands tax increases on the wealthy

As with the Senate and House bills, AT&T is negatively impacted by the Obama Health plan:

- **Medicare Part D:** The Senate proposal to tax Medicare Part D subsidies received by employers remained in the plan. If implemented, AT&T will need to immediately reflect a \$1.3B one-time expense on the P&L. This issue combined with closing the donut hole may drive AT&T to discontinue offering this coverage.
- **Coverage Penalties:** As noted above, AT&T will either pay a penalty for selected new hires during the six month waiting period, or we will need to reduce the waiting period to 90-days, which results in higher coverage costs.
- **Excise Tax:** The changes to the excise tax help AT&T but weaken our negotiating position with the union for the next two contract periods.
- **Medicare Reform:** Reductions in Medicare coverage, particularly those for Medicare Advantage, will shift industry expenses from Medicare to private and individual plans. The impact to AT&T could be as much as \$200M over the next ten years.
- **Tax on Non-wage Income for the Wealthy:** For individuals with income above \$200K and families with income above \$250K, the Obama plan adds a 2.9% tax on non-wage income including interest, dividends, annuities, royalties and rents. The tax on non-wage income for the wealthy reduces the attractiveness of high dividend stocks, including AT&T.

## Health Care Reform Analysis AT&T Policy Review – Obama Plan

BACKGROUND WITH PRELIMINARY ESTIMATES		
Provision	Bill and Timing	Estimated 10 yr. Cost to AT&T
<b>Excise Tax</b> <ul style="list-style-type: none"> <li>• <b>Senate:</b> Tax company plans with costs above benchmark levels of \$8,500 individuals and \$23,000 family, includes dental, vision, FSA, HRA, HSA</li> <li>• <b>Obama:</b> Increases thresholds to \$10,200 for individual and \$27,500 for family but excludes dental and vision; allows for age/gender adjustments</li> </ul>	Senate 2013 Obama 2018	Senate \$10-125M Obama < \$10M
<b>Medicare Part D Coverage Change</b> <ul style="list-style-type: none"> <li>• Expands coverage of the government's benchmark plan</li> <li>• With new benchmark, AT&amp;T doesn't qualify for subsidy on drug spend by non-grandfathered retirees (approx. post-1991 retirees)</li> </ul>	Obama (phased in to 2020)	\$200-300M
<b>Penalty for Not Offering Coverage</b> <ul style="list-style-type: none"> <li>• Employer pays subsidy to government if no coverage is provided or coverage is deemed unaffordable</li> <li>• Obama reduced unaffordability penalty to \$2,000 from the Senate \$3,000</li> </ul>	Senate (2014) Obama (2014)	\$170-255M \$110-\$170M
<b>Medicare Part D Subsidy</b> <ul style="list-style-type: none"> <li>• Tax subsidy AT&amp;T receives on prescription drugs for Medicare retirees</li> <li>• One time expense impact assumes the reduction in the deferred tax asset is immediately recognized through the income statement</li> </ul>	Both (2012)	\$1.3B one-time expense impact
<b>Medicare Payment Reforms</b> <ul style="list-style-type: none"> <li>• Reduces Medicare reimbursements, which helps AT&amp;T</li> <li>• Reduces Medicare Advantage (HMO) subsidies</li> <li>• Shifts expenses from Medicare to private / individual plans</li> </ul>	Both (Various from 2010–2014)	\$10-200M

# Health Care Bill Legislation

Bill Blase



at&t

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## Health Care Law

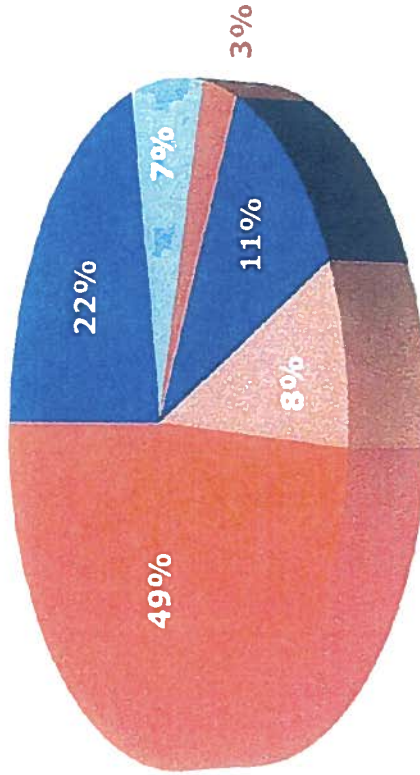
### Key Bill Components

1. Extends coverage to 32 million uninsured Americans
2. Individuals required to purchase coverage; subsidized for families with annual income below \$88,000
3. Employers required to provide minimum coverage or pay penalties
4. Insurance companies prohibited from denying coverage due to pre-existing conditions
5. Establishes health insurance exchanges with no public option at this time
6. Minimal progress on improving overall cost and quality of the healthcare system

# Health Care Law

➤ Total Cost \$938B

- Taxes on Wealthy
- Coverage Penalties
- Excise Tax
- Healthcare Industry Fees
- Other
- Coverage Reductions (Medicare)



## ➤ Funding Sources



# Key Impacts to AT&T

## ➤ Health Care Law

Provision	P&L Cost To AT&T (10-Year View)	Effective Date
Taxation of Medicare Part D Subsidy	\$1.0B one-time tax impact	2013 (Tax impact immediate)
Medicare Reform	\$10M-\$200M	Various
Excise Tax	< \$30M	2018
Pay or Play	\$90M-\$130M	2014
Dependents to 26 years old	\$50M-\$100M	2011



# Health Care Law

2009 Costs	(\$M)
Post-65 Rx Costs	\$633
Retiree Payments	(\$135)
<b>Net Company Cost</b>	<b>\$498</b>
Government Subsidy	(\$115)
<b>Final Company Cost</b>	<b>\$383</b>

## Medical Cost Summary

- AT&T currently receives a 23% subsidy on Medicare retiree drug costs, which totaled \$115M in 2009
- Subjecting the subsidy to income tax reduces the subsidy by 38% or \$44M
- Income tax expense results in one-time, non-cash 2010 P&L hit of approximately \$1B
- 8K filing required today



# Health Care Law

## ➤ Medical Cost Versus No Coverage Penalty

### 2009 Medical Costs

Active Employees	\$2.4B
Retirees	\$2.3B

**Total Company Cost \$4.7B**



### Penalty for No Coverage

Employees	283K
Annual Penalty per Employee	\$2K

**Total Annual Penalty \$0.6B**





# AFL-CIO

November 2, 2009

The Honorable Nancy Pelosi  
Speaker  
U.S. House of Representatives  
Washington, D.C. 20515

**Re: Retiree Health Coverage**

Dear Madam Speaker:

We are writing to express our serious concerns regarding two provisions included in H.R. 3200, The Affordable Health Care for America Act, and urge that they not be included in legislation approved by Congress. Section 110 would curtail the ability to change retiree health coverage and Section 534 would change the tax treatment of subsidies provided to employers who provide retiree drug coverage. Both provisions would likely have the unintended effect of discouraging the provision of employer-sponsored retiree health coverage, thereby undermining one of the goals of health reform legislation and placing the cost and burden of providing this vital coverage onto the federal government.

Section 110

Retiree health coverage has long been the subject of collective bargaining and is an important part of the overall package of benefits and compensation negotiated between labor and management. By severely restricting the ability to modify retiree health coverage this provision limits the flexibility that parties have during negotiations. In some situations, existing labor agreements already contain cost sharing arrangements that would be unilaterally overridden by this provision.

This restriction could unintentionally result in employers dropping sponsorship of retiree health coverage altogether to avoid future restrictions. Rising health costs and financial accounting rules have resulted in a steady erosion of employer-sponsored retiree coverage; and no doubt this decline is the motivation for this provision. It would be disastrous for millions of Americans still covered by retiree health plans to see those plans severely limited or eliminated altogether as employers seek to avoid being locked into a particular benefit in perpetuity.

Section 534

This provision of the bill would cease the current tax excludability of the 28% subsidy provided to employers who continue to provide prescription drug coverage to their retirees. The \$3 billion

in federal tax revenue estimated to be raised from this provision is highly unlikely to be realized. The current tax treatment was included in the Medicare Modernization Act of 2003 precisely to encourage employers to continue sponsoring drug coverage -- not only helping to preserve this important benefit, but also resulting in savings to the federal government by avoiding the necessity of many retirees to obtain Medicare Part D coverage. If only the tax revenue to be collected is calculated, but not also the federal outlays to provide the comparable benefit, then the actual cost to the government is not being accurately considered.

Moreover, Congress must consider the impact of this provision in the context of a reformed health system, as opposed to the current system. Other features of H.R. 3200, including the aforementioned limits on the ability to modify retiree health coverage, could well lead to an unintended and precipitous decline in some of the most comprehensive health coverage protection for retirees available today.

Finally, Congress has not considered at all the negative impact, required under Financial Accounting Standard 106, on the financial statements of companies that currently provide retiree health coverage. Regardless of the ultimate effective dates of Sections 110 and 534, accounting rules dictate that immediately upon being signed into law, these provisions would substantially increase the FAS 106 liability for the very companies providing the most comprehensive coverage to current and future retirees. In the current economic environment, this would be particularly ill-advised and disruptive.

Health care reform must be about stabilizing and expanding the employer-sponsored health benefits system. These two provisions would unnecessarily destabilize employer sponsored benefits for millions of retirees at a time of unprecedented changes in health coverage. Whatever differences the undersigned organizations may have on other aspects of pending health care reform legislation, on these two matters both labor and management are in full agreement. We respectfully urge that both these provisions be deleted from the legislation under consideration.

Sincerely,



Diann Howland  
Vice President, Legislative Affairs  
American Benefits Council



William Samuel  
Director, Department of Legislation  
AFL-CIO



December 15, 2009

The Honorable Harry Reid  
Majority Leader  
United States Senate  
Washington, D.C. 20510

Re: Patient Protection and Affordable Care Act

Dear Majority Leader Reid:

We are writing to express our serious concerns regarding two provisions included in the Senate's pending Health Care Reform legislation. Both provisions would impact the tax status of providing employee and retiree group benefit plans and both provisions impact the feasibility of continuing to provide such plans. The first provision affects the Medicare Part D subsidy for prescription drug coverage, which has significant implications for both retirees and employers participating in the Medicare Part D program to provide needed drugs. The second provision taxes high-value health plans, which we believe will result in diminished coverage for both active employees and retirees.

The Patient Protection and Affordable Care Act now being considered by the Senate changes the tax treatment of the financial support provided by employers to provide retiree drug coverage, effective in 2011. Placing a new tax on these employer subsidies is projected to raise \$5.4 billion over a 10-year period; but that projection assumes that no more than 25 percent of beneficiaries currently receiving this benefit from their former employer will move into the Medicare Part D program. In fact, we believe that many employers will see the need to drop or revamp their programs, moving more retirees into the government's program than those assumptions predict. Such movement of people from retiree plans will generate more costs to the federal government than revenues, thus adding to the federal deficit, rather than financing the health care reforms.

Congress should also be aware that the change in tax treatment would prove to be a distraction to the capital markets, at a time of grave economic uncertainty. That is because accounting rules dictate that, immediately upon the signing of the health reform legislation, employers would have to recognize, on their books, the long-term impact of the new tax liability.

While we commend your efforts to help mitigate the adverse impact of the 40 percent excise tax on high-cost plans, we continue to believe that, even in its current form, the tax is a misguided tool. If it was intended to address only excessive or luxury health benefits plans, it will, in fact, impact the health plans covering tens of millions of workers, including those in telecommunications, manufacturing,

construction, mining, public sectors. While the Congressional Budget Office estimates that 1 of every 5 workers would be impacted by the excise tax in 2016, the number of impacted workers will rise over time since the thresholds for the tax are significantly below actual health care cost increases.

The tax misses its mark because it assumes that high cost health plans have rich benefits. It does not recognize what we know to be true: the cost of health plans is heavily influenced by the age of the covered workforce and retirees, the proportion of covered dependents, the health status of the covered population, and the cost and practice patterns in the markets covered.

In order to avoid the additional financial burden of the 40 percent tax, many employers will be compelled to make significant changes in their benefit plans. Some predictable changes would be to cut back on dental and vision coverage, increase out of pocket payments by employees, and reduce family coverage. Further reductions in retiree coverage are also a certain result.

These two significant issues would likely have the unintended effect of discouraging the provision of employer-sponsored health coverage, thereby undermining one of the goals of health reform legislation and placing more of the cost and burden of providing this vital coverage onto the federal government.

As the legislation moves forward, we hope to work with you and your colleagues to ensure that health reform legislation extends health insurance coverage to millions of people who do not currently have coverage and guarantee that most Americans will have access to quality, affordable coverage. At the same time, we hope to assure that reform does not jeopardize the coverage that millions of Americans rely on to meet their health care needs.

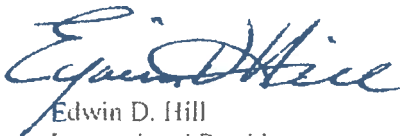
Sincerely,



Larry Cohen  
President  
Communications Workers of America



Ivan G. Seidenberg  
Chairman and CEO  
Verizon



Edwin D. Hill  
International President  
International Brotherhood of Electrical Workers



Randall L. Stephenson  
Chairman, CEO and President  
AT&T Inc.

## Accounting for Changes in Tax Deductibility of Retiree Health Costs Proposed in House and Senate Finance Committee Health Reform Bills

*The House has passed a bill proposing changes to the provision of health care in America. The bill, HR 3962, The Affordable Health Care for America Act (the Proposed Act), includes provisions to generate tax revenue to help offset the cost of the new legislation. One of these provisions would reduce the deductibility of retiree health care costs to the extent of federal subsidies received by plan sponsors that provide retiree prescription drug benefits equivalent to Medicare Part D coverage. This provision also appears in the Senate Finance Committee (SFC) health reform bill. If this provision is enacted into law, many employers would be subject to additional taxes, and the reduction in the deferred tax asset related to the additional tax would be recognized in the income statement in the period in which the new legislation is enacted.*

### Background

In 2003, the Medicare Prescription Drug, Improvement and Modernization Act (the 2003 Act) was signed into law. The 2003 Act introduced a prescription drug benefit under Medicare Part D, as well as a federal subsidy to sponsors of retiree health benefit plans that provide a benefit that is at least actuarially equivalent to the benefits under Medicare Part D. This subsidy is known as the Retiree Drug Subsidy (RDS). Employers are not currently taxed on the RDS payments they receive.

In response to the 2003 Act, the FASB issued FSP FAS 106-2, *Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003*, which addressed the accounting for the change in the benefit obligation due to the expected subsidies to be received, as well as the accounting for the related tax implications. Since the subsidy is not subject to tax, the guidance indicates that the subsidy's impact on the benefit obligation should have no bearing on any plan-related temporary difference accounted for under ASC 740, *Income Taxes* (formerly FAS 109, *Accounting for Income Taxes*). Thus, the measure of any temporary difference related to the benefit obligation is currently determined as if the subsidy did not exist.

### Accounting for Deferred Taxes under the Proposed Act

The Proposed Act contains a provision that would change the tax treatment related to the RDS, by requiring the amount of the subsidy received to be

offset against the employer's deduction for health care expenses. That is, the proposed change in tax treatment would not affect the taxation of the subsidy itself, but would reduce the employer's deduction for the costs of health care for retirees by the amount of the subsidy received.

As a result, if the Proposed Act is enacted, the deductible temporary difference and any related deferred tax asset associated with the benefit plan will be reduced. Under ASC 740, the impact of the change in tax law should be immediately recognized in continuing operations in the income statement for the period that includes the enactment date, regardless of the effective date of the change in tax law<sup>1</sup>. This immediate income statement recognition is required for the change in tax law even though some portion of the accumulated actuarial gains or losses related to the subsidy may be recorded in accumulated other comprehensive income in the balance sheet.

**Observations:** *The impact of this provision may be significant both economically and from a financial reporting perspective. The new health care bill would effectively result in a new tax that employers would be required to pay on the federal subsidy received for retiree prescription drug benefits.*

*The impact of the new tax would be recognized immediately in the income statement upon enactment*

<sup>1</sup> Under the House bill HR 3962, the tax change is effective for tax years beginning after 12/31/2012. Under the Senate Finance Committee bill, the change is effective for tax years beginning after 12/31/2010.

of the Proposed Act. For many employers, the income statement impact would equal the difference in the retiree benefit obligation for prescription drug coverage computed "with" and "without" subsidy, times the corporate tax rate. In addition, the employer's effective tax rate would be adversely affected in future periods by this change. Note, however, for employers that have reflected a valuation allowance against their deferred tax assets under ASC 740, the proposed bill would have no financial statement impact.

The proposed law changes would have no effect on the benefit obligation recognized for accounting purposes since the proposal contains no changes in how actuarial equivalence or subsidy payments are determined.

Some employers may consider plan changes that would make their plan not actuarially equivalent to the benefits under Medicare Part D, thereby disqualifying them from receiving subsidy payments in the future. Such an amendment would be treated as a negative prior service cost under FSP FAS 106-2 (codified in ASC 715-60), even though some of the original gain from the anticipated subsidy remained in accumulated other comprehensive income. In that case, the reduction in the deferred tax asset related to the loss of the expected subsidy would be reflected in other comprehensive income as part of the accounting for the amendment (not directly in the income statement as above). However, this treatment would be appropriate only if the amendment is adopted by the employer prior to the enactment of the new law.

**Illustrating the Income Statement Impact**

Prior to the Proposed Act, assume that a company has a benefit obligation reflected as a liability on the balance sheet of \$72, relating to prescription drug benefits for Medicare-eligible retirees, and a deferred tax asset of \$35. As shown in the first column of the table below, the \$35 equals the tax rate multiplied by the deductible temporary difference of \$100, which is the applicable benefit obligation on a "without subsidy" basis.

At the enactment date of the Proposed Act, the benefit obligation on the balance sheet would remain \$72, but the deductible temporary difference would be reduced to the extent that future benefit payments will no longer be tax deductible. The resulting reduction in deferred tax asset would be recognized in continuing operations in the income statement in the period in which the Proposed Act is enacted, through a charge to the income tax provision. Since the proposed Senate Finance Committee and House bills have different

proposals for the effective date, the effect of the new law would be somewhat different under each bill, as shown in the table below.

	Current Law	At Enactment of Proposed Act	
		SFC Bill	House Bill
Accumulated Postretirement Benefit Obligation (APBO) "with subsidy" (balance sheet liability) <sup>1</sup>	\$72.0	\$72.0	\$72.0
(1) Benefit obligation "without subsidy" <sup>2</sup>	\$100.0	\$100.0	\$100.0
(2) Benefit obligation attributable to future RDS payments expected to be received after effective date of new law	n/a	\$26.5	\$24.0
(3) Deductible temporary difference = (1) - (2)	\$100.0	\$73.5	\$76.0
(4) Assumed tax rate	35%	35%	35%
(5) Deferred tax asset = (3) * (4)	\$35.0	\$25.7	\$26.6
<b>Decrease in deferred tax asset and net income due to law change</b>	n/a	\$9.3	\$8.4

<sup>1</sup> Represents the portion of the employer's APBO related to prescription drug coverage for Medicare-eligible retirees and future retirees that reflects the expected subsidy to be received in future years.

<sup>2</sup> Represents same obligation as under footnote 2 but without consideration of expected subsidy.

**Where You Can Find More Information**

More information on accounting for changes deferred taxes resulting from changes in tax law can be found in the PwC Guide to Accounting for Income Taxes, Chapter 7.

**How PwC Can Help**

PwC has considerable expertise in the accounting, tax, actuarial and HR issues related to active and postretirement medical benefit plans, including a deep knowledge of the various options available to employers in the Medicare marketplace. We can leverage this expertise to provide employers with a broad perspective on costs, financial reporting, tax and other implications as they re-assess their benefit plan offerings in consideration of pending health reform.

For more information on the topic discussed in this *HRS Insight* or to change your address, contact your local PricewaterhouseCoopers professional

Atlanta, GA	Ann O'Connell	678-419-2820	Los Angeles, CA	Charlie Wheeler	415-498-5000
	Charlie Yovino	678-419-1330	New York Metro	John Caplan	646-471-3646
Boston, MA	Ed Donovan	617-530-4722		Ed Donovan	646-471-8855
	Matthew Cowell	617-530-5694		Scott Olsen	646-471-0651
Charlotte, NC	Charlie Yovino	704-344-7739	Philadelphia, PA	Ted Volz	267-330-3180
Chicago, IL	Pat Meyer	312-298-6229		Bruce Clouser	267-330-3194
	Jack Abraham	312-298-2164		Bill Dunn	267-330-6105
	Paul Perry	312-298-3157	San Francisco, CA	Julie Rumberger	408-817-4460
	Terry Richardson	312-298-3717	San Jose, CA	Scott Pollak	408-817-7446
Dallas, TX	Charlie Wheeler	214-754-5023		Julie Rumberger	408-817-4460
Detroit, MI	Theresa Gee	312-298-4700	St. Louis, MO	Terry Richardson	312-298-3717
Kansas City, MO	Terry Richardson	312-298-3717	Washington, DC	Jeff Davis	202-414-1857
				Nik Shah	703-918-1208

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**Accounting for Reduced Retiree Health Tax Deduction  
Related to Medicare Part D Subsidy**

The Patient Protection and Affordable Care Act (PPACA), enacted March 23, 2010, and the Health Care and Education Reconciliation Act of 2010 (the "Reconciliation Act"), enacted March 30, 2010, modify the tax treatment related to a federal subsidy available to sponsors of retiree health benefit plans with a drug benefit that is at least actuarially equivalent to the benefits under Medicare Part D.

The subsidy is known as the Retiree Drug Subsidy (RDS) and came into existence with the enactment of the Medicare Modernization Act (MMA) in 2003. Prior to the enactment of PPACA, employers were permitted to deduct from taxable income their full costs of their retiree drug programs, without reduction for the federal subsidy received (Internal Revenue Code sec. 139A). The PPACA and the Reconciliation Act require the employer tax deduction to be reduced by the RDS. Under the PPACA this change would be effective beginning in 2011. The Reconciliation Act delays this change to 2013.

U.S. Generally Accepted Accounting Principles (GAAP), as determined by the Financial Accounting Standards Board (FASB), require the impact of the change in tax law of the RDS under PPACA (and, subsequently, the change under the Reconciliation Act) to be immediately recognized in the income statement in the period that includes the enactment date.<sup>1</sup> This is true regardless of the effective date of the change in tax law. Disclosure of this impact generally is required if the amount to be recognized is material.

Under GAAP, the expected cost of earned future retiree health benefits is recorded as a liability on the employer's balance sheet.<sup>2</sup> When MMA was enacted in 2003, this liability was reduced to reflect the RDS. In addition, the value of future tax deductions for these retiree health benefits is recorded as an asset (known as a "deferred tax asset") on the employer's balance sheet. The retiree health liability, minus the deferred tax asset, reflects the employer's expected net cost of earned future retiree health benefits.

The impact of the change in tax law of the RDS is to reduce the tax deduction for earned future retiree health benefits, which in turn reduces the value of future tax deductions recorded as a deferred tax asset. This results in an increase in the net cost of earned future retiree health benefits.

As noted above, this increased cost (which applies for future years only) is recognized in the income statement for the period that includes the enactment date of the law change. Many corporations will recognize this increased cost in the quarter ending March 31, 2010. Because of fiscal years, other companies may recognize this cost in quarters that end in April or May.

It is important to note that GAAP has special rules for recognizing the impact of other changes to the expected cost of earned future retiree health benefits made by the PPACA and the Reconciliation Act, which will be recognized by the end of the employer's current year. In contrast to the GAAP rules for tax law changes (which require a charge to current earnings at the enactment date), GAAP will generally require the effects of other changes in earned future retiree benefits to be adjusted into earnings over a number of years.

<sup>1</sup> ASC (Accounting Standards Codification) 740 (formerly FAS 109), paragraph 10-45-15, states "when deferred tax accounts are adjusted ... for the effect of a change in tax laws or rates, the effect shall be included in income from continuing operations for the period that includes the enactment date."

<sup>2</sup> ASC 715 (formerly FAS 106 and FAS 158) addresses the accounting treatment of retirement benefits.

**Accounting for Reduced Retiree Health Tax Deduction Related to Medicare Part D Subsidy (April 5, 2010)**

**Q&A on Accounting and Disclosure**

**Q1 - The PPACA, signed by the President on March 23, 2010, requires the RDS to reduce the employer's deduction for retiree drug benefits beginning in 2011 (revised to 2013 in the Reconciliation Act signed into law on March 30, 2010). What is the accounting impact of these two measures?**

A1 - The accounting literature is clear.<sup>3</sup> The cumulative impact associated with the change in deductibility of earned future retiree drug benefits is immediately recognized in the income statement upon enactment of each bill. Upon enactment of PPACA a charge is recorded for the reduced deductibility beginning in 2011. Upon enactment of the Reconciliation Act, a benefit is recorded for restoration of deductibility for 2011 and 2012. Many corporations will recognize this increased net cost in the quarter ending March 31, 2010.

**Q2 - What does the income statement charge represent?**

A2 - Essentially, the charge represents the employer's expected increase in tax costs associated with earned future retiree health benefits.

**Q3 - Why isn't the impact of other aspects of the legislation being recognized currently?**

A3 - With respect to other aspects of the legislation impacting the cost of employer-provided retiree health care, the estimated impact on future net costs on the liability (whether an increase or decrease to the retirement benefit liability) *will* be recognized under GAAP by the end of the company's current fiscal year. However, instead of reflecting the impact immediately in earnings, GAAP generally requires these effects to be adjusted into earnings over a number of years.

Also, GAAP does not recognize the impact currently of legislation that will change the expected cost of employer-provided health care to active employees. Instead, the increases or decreases in net cost will be recognized in the period the benefits are provided.

**Q4 - Is the tax charge being taken in the income statement a "non-cash charge"?**

A4 - The tax charge is non-cash, in that it will not have an immediate cash flow impact because of the delayed effective date. The charge represents the increase in the employer's expected future cash outflows associated with incremental income taxes as a result of the reduced deductibility on earned future retiree benefit payments.

**Q5 - Are there circumstances in which an employer that receives the RDS would not have to recognize this tax charge in the income statement?**

A5 - There are a number of potential scenarios in which a tax charge may not be required:

- If the employer is not currently a taxpayer (due to operating losses or other reasons), it may already have recorded a valuation allowance (i.e., reserve) against its deferred

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<sup>3</sup> Accounting for income taxes literature in ASC 740 (formerly FAS 109). Specifically, ASC 740-10-45-15, which states "when deferred tax accounts are adjusted... for the effect of a change in tax laws or rates, the effect shall be included in income from continuing operations for the period that includes the enactment date."

tax assets and therefore any required adjustment would have no net financial accounting impact.

- Some employers made amendments to their benefit plans prior to enactment of the legislation on March 23, 2010, which disqualified the employer from receiving the RDS. Since the employer was no longer entitled to the RDS, the new tax law would have no impact.
- Companies that do not apply U.S. GAAP (for example, those reporting under IFRS), may not have income statement charges, due to differences in the accounting rules.
- For some companies a tax charge is recorded, but if the impact is not material, it might not be separately disclosed.

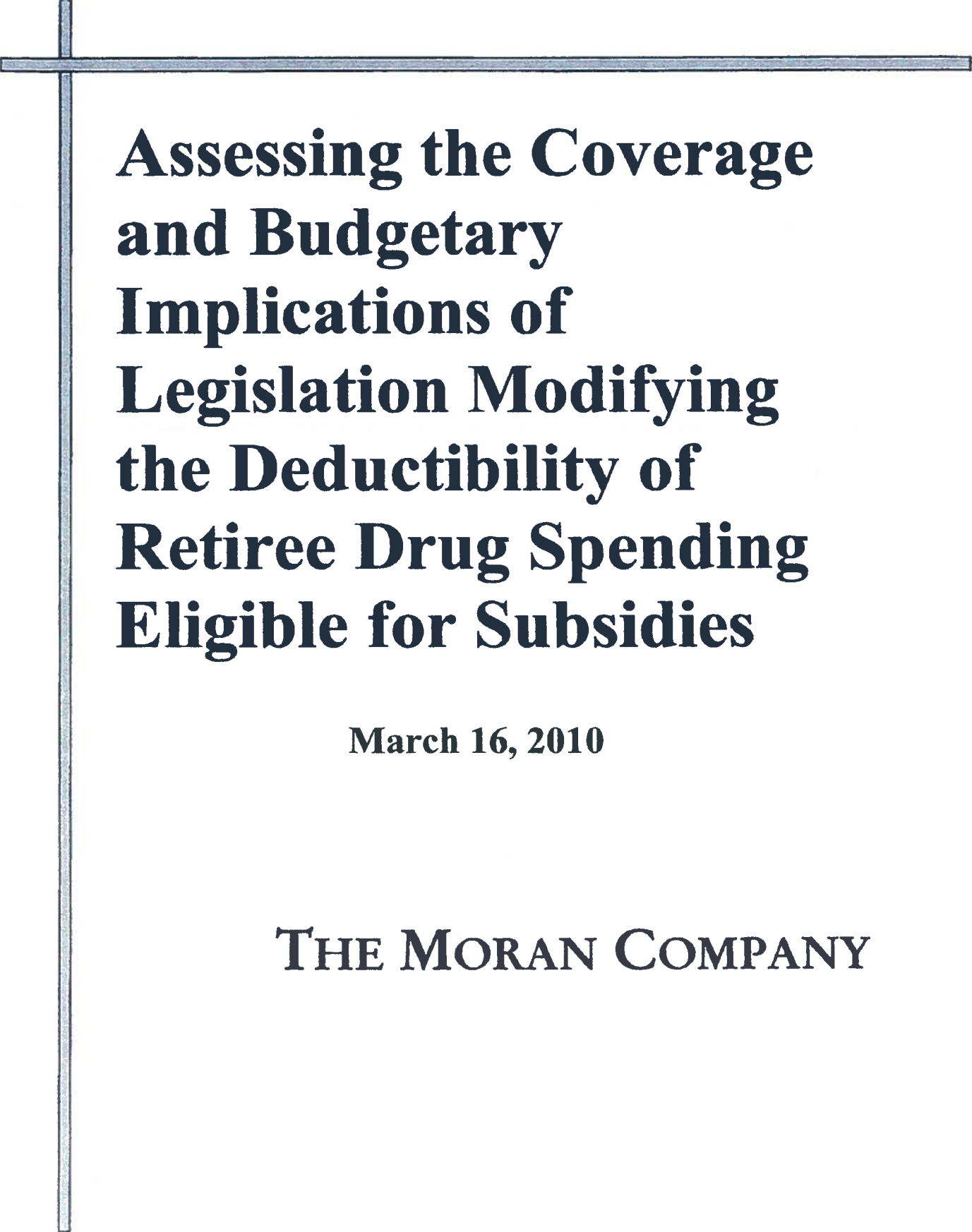
**Q6 - What disclosures of the tax charges are required?**

A6 - If material, companies would disclose the impact of the tax law change in their next quarterly filing with the SEC on Form 10-Q. This form is generally filed with the SEC three to six weeks after the end of the quarter (for most companies, the filings will be made in late-April through early-May).

Additionally, SEC regulations state that a registrant may, at its option, disclose any event that the registrant deems of importance to security holders. This disclosure is made in a Form 8-K filing under Item 8.01 Other Events. Generally the SEC encourages companies to make these types of Form 8-K disclosures to alert investors to any significant events that occur between quarterly filings. Decisions about whether to file a Form 8-K are legal matters that companies should consider discussing with their counsel. In considering whether to file a Form 8-K, the company may consider both quantitative and qualitative factors.

**Q7 - How does a company assess whether a transaction is material?**

A7 - The SEC provides guidance on assessing materiality (in Staff Accounting Bulletin No. 99). SAB 99 states that a matter is 'material' if there is a substantial likelihood that a reasonable person would consider it important. The assessment should include both quantitative and qualitative factors.



**Assessing the Coverage  
and Budgetary  
Implications of  
Legislation Modifying  
the Deductibility of  
Retiree Drug Spending  
Eligible for Subsidies**

**March 16, 2010**

**THE MORAN COMPANY**

## Assessing the Coverage and Budgetary Implications of Legislation Modifying the Deductibility of Retiree Drug Spending Eligible for Subsidies

In fashioning the Medicare Modernization Act of 2003 (MMA), which created the outpatient prescription drug benefit under Medicare Part D, the Congress enacted substantial incentives for employers to continue to offer drug benefits through their existing retiree health insurance plans. Employers electing to enroll in a newly-created Retiree Drug Subsidy (RDS) program would be eligible for subsidies equal to 28% of their actual amount of spending within a defined corridor.<sup>1</sup> Since such employers could continue to deduct the full amount of their retiree drug spending on behalf of Medicare beneficiaries from their corporate income taxes, this subsidy provided a substantial incentive for employers to continue private coverage, especially for employers subject to the corporate income tax.

The 28% subsidy rate was determined by the Congressional Budget Office (CBO), at the time the MMA policy was being finalized, to be effectively budget neutral to the level of subsidies that would otherwise be made were these beneficiaries to enroll in the regular Part D program.<sup>2</sup> This estimate took account of the fact that individuals remaining in the retiree health benefits program would have supplemental coverage for some or all of their out-of-pocket drug spending, and hence would reach the "true out-of-pocket spending (TROOP)" threshold for catastrophic coverage more slowly than regular Part D enrollees without enhanced coverage.

In the health care reform debate of 2009-2010, policymakers are considering a substantial reversal of this policy. The reform bill as passed by the Senate would maintain the 28% subsidy, but would disallow corporate income tax deductions for the amount of spending equal to the amount of the subsidy. The Joint Committee on Taxation (JCT) estimated that this provision would raise revenues by \$1.9 B over 2010-2014, and by \$5.4 B over 2010-2019.<sup>3</sup>

This estimate, however, did not reach the question of whether there would be associated changes in Federal outlays. This question arises because if some number of employers were to terminate participation in the RDS, having their beneficiaries enroll in regular Part D could cause Federal subsidy costs under Part D to rise, offsetting some or all of the revenue effect estimated by Joint Tax. CBO, the scorekeeping entity normally responsible for making outlay estimates, has not yet publicly released an estimate of the outlay effects of this provision. The Moran Company was engaged by the American Benefits Council, a trade group of employers active in the employee benefits policy arena, to assess this policy, and identify the issues CBO would likely

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<sup>1</sup> In 2006, the subsidy applied to costs in excess of \$250 per enrollee, but less than \$5,000. These amounts were subsequently indexed upwards at the same rate as other indexed values under the statute.

<sup>2</sup> It is our understanding that that estimate did not take into account the budget implications of continuing deductibility for spending eligible for subsidies—because that provision was not added until conference.

<sup>3</sup> Joint Committee on Taxation, *Estimated Revenue Effects of the Manager's Amendment to the Revenue Provisions Contained in the "Patient Protection and Affordable Care Act."* JCX-61-09, December 19, 2009.

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need to consider to “score” this provision if it were viewed as a free-standing amendment to current law.<sup>4</sup>

Our findings are as follows:

- We expect CBO to conclude that a significant share of employers participating in the RDS would discontinue participation if this provision were enacted.
- To the extent that those employers maintained their level of retiree drug benefits but elected to restructure their retiree benefit plans to offer supplemental benefits as enhanced plans under Part D, the effect on outlays would depend on how accurately the 28% subsidy amount originally estimated by CBO reflects subsequent reality.
- To the extent that employers reduced the level of retiree drug benefits, however, enrollees electing to enroll in Part D would have a higher Federal subsidy cost due, at least in part, to higher catastrophic outlays than those assumed for RDS enrollees.
- Using a model that was constructed to be consistent with the Joint Tax revenue estimates, we find that the deficit impact of the policy is highly sensitive to the assumptions that CBO might make regarding the willingness of retiree drug plan sponsors to maintain supplementation for Part D cost sharing.

In the balance of this report, we present the rationale for these findings.

### Baseline Estimates of Taxable RDS Activity

In its Winter 2009 Baseline, CBO projected a separate estimate for the amount of RDS spending:

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
CBO Baseline, RDS Subsidies (\$B)	\$3.7	\$3.1	\$3.1	\$3.3	\$3.6	\$3.9	\$4.2	\$4.5	\$4.9	\$5.3	\$5.7	\$6.1	\$6.5

As indicated in the table, CBO projected that RDS spending would decline in 2009, and then begin rising to the level of \$6.5 billion by 2020.<sup>5</sup> While CBO did not present separate estimates of the enrolled population in plans receiving RDS subsidies, the Social Security Trustees’ 2009 report projects enrollment in RDS plans as follows:

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Trustees Intermediate RDS Enrollees (#M)	6.6	6.3	6.3	6.3	6.4	6.4	6.5	6.5	6.6	6.7	6.7	6.8	6.8

<sup>4</sup> Our decision to analyze this policy relative to current law, while fully consistent with normal scorekeeping conventions, was made after taking into account the fact that other policy changes to the Part D program enacted simultaneously with the provision under evaluation – such as proposals to eliminate the so-called “donut hole” – would materially affect how CBO might analyze the incremental effect of this provision.

<sup>5</sup> Throughout this analysis, we have extrapolated final year growth rates to 2019-2020.

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In understanding the effect of the proposed change in tax policy, it is important to take account of the fact that a significant number of plans receiving RDS subsidies are sponsored by non-taxable entities, and hence would be financially unaffected by the provisions under evaluation. While both projections cited exclude Federal retirees, they include state and local government retirees, as well as retirees from tax-exempt entities (e.g., 501(c)(3) hospitals). Hence to determine the subset of taxable RDS plan sponsors, we needed to adjust these projections downward to exclude effects on sponsors that don't pay corporate income taxes. To adjust for state and local employees, we used data from the Economic Report of the President, 2009, to decompose the current workforce between state, local and other employees. We assumed that the distribution of retirees (with and without health benefits) was proportional to the distribution of the workforce, but that the distribution of retiree health benefits differed across sectors. We used estimates of the prevalence of retiree health benefits in various sectors previously published in reports by the Employee Benefit Research Institute to estimate the amount of outlays and enrollment to exclude for state and local government retirees.<sup>6</sup> Lacking evidence to the contrary, we assumed that the prevalence of retiree drug benefits was, across all sectors, proportional to the prevalence of health benefits. We then decomposed the private workforce between the for-profit and not-for-profit sectors based on the assumption that retirees in the not-for-profit sector comprised 10.9% of the private total.<sup>7</sup> We implicitly assumed that the prevalence rate of retiree health benefits in both sectors was comparable.

Relative to this population baseline, we also needed to take into account the use of Voluntary Employee Benefit Associations (VEBAs). The conversion of the United Auto Worker plans (General Motors, Ford and Chrysler) to VEBAs means that, regardless of whether the not-for-profit VEBA continues in RDS, the plan sponsors would no longer be subject to corporate income taxation. The UAW plans alone cover approximately one million retirees in 2008; given the limited number of plan sponsors eligible to use VEBAs for this type of arrangement, we assumed zero net growth over the period.

Assuming that beneficiaries participating in the RDS have average annual costs, our estimate of the share of the RDS baseline sponsored by entities subject to corporate income taxation is thus as follows:

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
CBO Baseline, RDS Subsidies (\$B)	\$3.7	\$3.1	\$3.1	\$3.3	\$3.6	\$3.9	\$4.2	\$4.5	\$4.9	\$5.3	\$5.7	\$6.1	\$6.5
Exclude Non-Taxable Entities (\$B)				-\$0.8	-\$0.9	-\$1.0	-\$1.0	-\$1.1	-\$1.2	-\$1.3	-\$1.4	-\$1.5	-\$1.6
Exclude VEBA				-\$0.5	-\$0.5	-\$0.6	-\$0.7	-\$0.7	-\$0.8	-\$0.9	-\$1.0	-\$1.2	-\$1.3
Baseline RDS Payments to Taxable Entities				\$2.0	\$2.2	\$2.3	\$2.5	\$2.6	\$2.9	\$3.1	\$3.2	\$3.4	\$3.6

<sup>6</sup> As cited in Dailey, D.M. and Cogburn, J.D. *Retiree Health Care in the American States* (Center for State & Local Government Excellence, December 2008).

<sup>7</sup> Moran Company estimate generated from data presented in Warren, Z. "Occupational employment in the not-for-profit sector", *Monthly Labor Review*, November, 2008, p. 11-43.

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## The Value of RDS Deductions

The next stage in our analysis involved investigating the relationship between our baseline estimate and the Joint Tax estimate of the revenue yield from the change in deductibility. Since the amount of the deductions that would be disallowed under the Senate policy is exactly equal to the amount of the RDS subsidy, we can directly estimate the “static” effects of this tax policy, that is, the amount of revenues that would be raised if no employers withdrew from the RDS program.

The table below presents our analysis of the Joint Tax score.

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Baseline RDS Payments to Taxable Entities	\$2.0	\$2.2	\$2.4	\$2.6	\$2.8	\$3.1	\$3.3	\$3.6	\$3.8	\$4.1
Gross Amount of Associated Deductions	\$2.0	\$2.2	\$2.4	\$2.6	\$2.8	\$3.1	\$3.3	\$3.6	\$3.8	\$4.1
Corporate Tax at 35% Tax Rate	\$0.7	\$0.8	\$0.8	\$0.9	\$1.0	\$1.1	\$1.2	\$1.2	\$1.3	\$1.4
JTC Tax Score	\$0.3	\$0.5	\$0.5	\$0.6	\$0.6	\$0.6	\$0.7	\$0.7	\$0.8	\$0.8
Effective Tax Rate	42%	64%	59%	66%	61%	56%	60%	56%	60%	56%

In this analysis, we compare the revenue effect that Joint Tax scored to our estimate of the amount of corporate tax liability that would be assessed at the 35% top effective rate. We use the top rate to value the tax liability to reflect the fact that retiree health benefits are typically offered by very large corporations who disproportionately pay the top rate.

As this analysis shows, the Joint Committee on Taxation’s estimate of the revenue effects of this policy is markedly lower than the amount we estimate would be assessed if all taxable employers continued to participate in the RDS. Since the JCT estimate does not reflect budgetary offsets due to outlays, the only explanation we find reasonable is that the Committee assumes that a significant share of RDS plan sponsors would quickly convert to other arrangements, allowing their retiree drug spending to remain fully deductible. The JCT estimate is consistent with a 35-45% reduction in the number of RDS enrollees from taxable plans. This translates into an estimated 1.5 million to 2 million Medicare beneficiaries whose drug coverage would change as a result of this policy.

## Incentives to Discontinue RDS Participation

There are at least two incentives for employers to discontinue RDS participation to the extent that RDS subsidies are no longer deductible. First, reducing deductibility of retiree benefits expenses markedly dilutes the incentives to continue offering retiree drug coverage. The Senate policy would reduce the economic value of the RDS subsidy by more than a third. While many plan sponsors would undoubtedly continue to find that the value of the subsidy makes it financially worthwhile to continue maintaining the benefit, other plan sponsors could now find that the financial balance tips the other way.

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Second, plan sponsors who elect to remain in the RDS program would need to take an immediate charge to their reported current year earnings to effectively write off the value of the future tax benefit. This is due to accounting requirements stipulated in Accounting Standards Codification 740, *Income Taxes*. For companies whose retiree health benefits costs are large relative to their current earnings, the required charges could substantially impair, if not eliminate, current year earnings.

Hence it seems likely that CBO would proceed from the assumption that a meaningful share of RDS plan sponsors would discontinue RDS participation for Part D enrollment, with greater or lesser degrees of benefits supplementation continuing to be provided to enrollees.

### **Assessing the Outlay Consequences**

CBO's analysis of the outlay implications of this shift will turn on its view of exactly how employers will change their plans in response.

If all employers who leave the RDS elect to convert their drug benefit plans to enhanced coverage under the Part D benefit to make the net benefit equal to their prior benefit, CBO might conclude that the Federal budgetary effect would be negligible. This statement assumes that CBO's prior estimate of a 28% expected value to sponsors of Retiree Drug Coverage under current law remains accurate. If so, outlays for subsidies under Part D for former RDS participants would be comparable to the subsidy now paid under current law, and outlays could remain unchanged. If, however, CBO finds that the assumed utilization patterns have shifted to the point where the 28% subsidy now overpays or underpays relative to the equivalent Part D benefit, outlays would go up or down as beneficiaries moved from RDS to Part D.

If any significant number of employers exiting the RDS either drop retiree drug coverage, or elect to secure it by subsidizing premiums for Part D enrollment, we expect CBO to conclude that Federal subsidy costs would rise substantially relative to the current law 28% subsidy amount. This is due to the fact that either move would expose retirees to the full effect of Part D cost sharing rules, without the benefit of supplemental coverage.<sup>8</sup> Because its prior 28% budget neutrality estimate was based on the assumption that RDS enrollees would qualify for the catastrophic benefit far more slowly than the average Part D participant, CBO would most likely conclude that subsidy costs for such beneficiaries moving from RDS to Part D would be higher than 28%.

Were CBO to evaluate this policy, the largest single determinant of its budgetary evaluation would turn on the assumed percentage of RDS disenrollees that will be transferred to Part D without supplementary benefits.<sup>9</sup> As noted above, CBO might score some change in spending as a result of re-evaluating its prior estimate that a 28% subsidy was budget-neutral to the Federal

<sup>8</sup> Regular Part D enrollees are, under the statute, prohibited from purchasing supplemental insurance plans.

<sup>9</sup> While our model explicitly treats this choice as binary, our model could be interpreted to be congruent with a continuous gradient between "full supplementation" and "no supplementation."

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costs of regular Part D benefits for RDS plans. We would expect these estimates to be small, however, in comparison to the budgetary effects of decisions by RDS plan sponsors to continue to supplement beneficiary cost sharing under Part D. If CBO were to conclude that former RDS plans would all continue to supplement, they would score the effects of moving RDS plans into Part D as being negligible. If, by contrast, they assumed that a substantial share of former RDS sponsors would reduce their effective rate of supplementation in converting to Part D coverage, we anticipate that CBO would score a substantial increase in Federal subsidy costs due to the accelerated conversion of former RDS enrollees into catastrophic coverage.

While the initial evidence of how retiree benefit plan sponsors made their elections for 2006 may shed some light on the question, those elections were made in the presence of an RDS incentives policy that would be materially diminished under the Senate policy. Furthermore, applicable accounting rules would result in a significant increase in financial liability for many taxable RDS sponsors under the Senate provisions, further diminishing incentives to participate in the RDS program. CMS publishes an annual list of RDS plan sponsors, but does not provide enrollment data that would permit analysts to even roughly estimate how non-RDS enrollment choices were made by different types of plan sponsors in 2006. Given this reality, we expect that CBO would need to make a *pro forma* assumption about the probability that retiree benefit plan sponsors would choose a non-supplementation benefits modification strategy as they exited the RDS program.

## **Conclusion**

The change in tax policy under the Senate bill, as well as the corresponding requirement for RDS sponsors to take an immediate accounting charge to earnings, are two significant incentives for employers to discontinue RDS participation.

Our analysis concludes that the outlay impact of the change in RDS tax policy is highly sensitive to how CBO elects to look at the question of whether employers leaving the RDS will restructure their benefit designs to supplement Part D cost sharing. During the course of this project, we have, through the American Benefits Council staff, received information from confidential interviews with benefits consultants who advise plan sponsors on these matters. Having said that, this information cannot support a point estimate of the net degree of supplementation that would be available to former RDS beneficiaries enrollees in Part D. However, this information supports the view that, should the Senate policy be adopted, the rate of defections from the RDS would be high. It also supports the view that a significant number of employers may not automatically restructure their plans in ways that minimize costs to the government.

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ATTACHMENT 1: CALCULATION OF DEFERRED TAX ASSET FOR MEDICAL PART D

	(1)	(2)	(3) = (1) - (2)	(4)	(5) = (3) * (4)
(\$M)	Estimated Annual Retiree Drug Subsidy (RDS) Payments	Adjust for 2013 Starting Date for New Law	Adjusted Annual RDS Payments	Present Value Factor	Present Value of Adjusted Annual RDS Payments
2010	(113)	113	0		0
2011	(121)	121	0		0
2012	(132)	132	0		0
2013	(143)		(143)	0.796	(114)
2014	(154)		(154)	0.746	(115)
2015	(165)		(165)	0.698	(115)
2016	(177)		(177)	0.657	(116)
2017	(189)		(189)	0.625	(118)
2018	(201)		(201)	0.579	(116)
2019	(212)		(212)	0.543	(115)
2020	(221)		(221)	0.524	(116)
2021	(230)		(230)	0.489	(112)
2022	(239)		(239)	0.457	(109)
2023	(247)		(247)	0.421	(104)
2024	(254)		(254)	0.398	(101)
2025	(261)		(261)	0.376	(98)
2026	(267)		(267)	0.356	(95)
2027	(270)		(270)	0.330	(89)
2028 and beyond	(7,508)		(7,508)	0.133	(998)
<b>Total</b>	<b>(11,104)</b>		<b>(10,738)</b>		<b>(2,633)</b>

ATTACHMENT 2: CALCULATION OF MEDICAL PART D ACCOUNTING ADJUSTMENT IN 8-K FILING

Row	Description	(\$B)
A	Present Value of Annual RDS Payments	(2.6)
B	Tax Rate	38%
<b>C = A * B</b>	<b>Required Accounting Adjustment for Part D Law Change</b>	<b>(1.0)</b>