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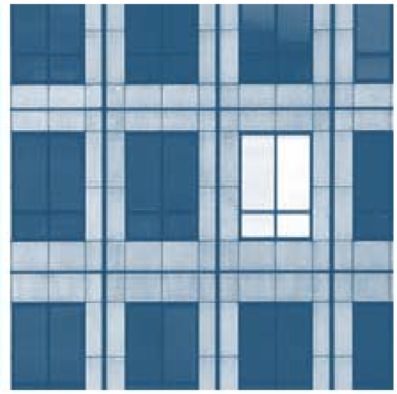
On the Subject



Health Industry Advisory

July 21, 2010

Employers that provide retiree prescription drug coverage should analyze the increased future tax liability and the current accounting charges necessary to retain retiree prescription drug coverage, and evaluate the practical and legal risks of eliminating this benefit.

Health Care Reform: Elimination of Retiree Drug Subsidy Deduction

Employers that currently receive a federal subsidy for providing retiree prescription drug coverage (Retiree Drug Subsidy) will no longer be able to take a deduction for those retiree drug expenses with respect to that subsidy as of 2013 under the Patient Protection and Affordable Care Act, as amended by the Health Care and Education Reconciliation Act of 2010 (PPACA).

History of the Retiree Drug Subsidy

The Retiree Drug Subsidy was established by the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (MMA) for employers that sponsor group health plans providing prescription drug benefits to retirees. The MMA created the Medicare Part D Program to provide prescription drug coverage to Medicare participants. The Retiree Drug Subsidy was designed to encourage employers to continue offering prescription drug benefits to their retirees as opposed to terminating their retiree prescription drug benefit plans and thus requiring retirees to seek benefits through Medicare (which would be costly to taxpayers). Under the MMA, certain employers were qualified to receive a subsidy equal to 28 percent of covered prescription drug costs for their retirees. Employers were entitled to an income tax deduction upon receipt of the subsidy and were permitted to take into account this deduction when accounting for their retiree prescription drug expenses.

How Does the Elimination of the Income Tax Deduction for the Retiree Drug Subsidy Affect Employers That Provide Retiree Prescription Drug Coverage?

The PPACA retains the Retiree Drug Subsidy, but eliminates employers' ability to deduct the amount of the subsidy. This change increases an employer's income tax liability, in effect increasing the employer's cost of providing prescription drug coverage to retirees. The amount by which an employer's tax liability will increase depends on the total amount of the subsidy and the employer's applicable corporate tax rate, which currently ranges from 15 percent for income below $50,000 to 35 percent for income over $10 million.

Although employers will not face the higher tax liability until 2013, under financial accounting rules, employers must now include the present value of the future taxes as a current liability charged against earnings.

How Are Employers Responding to the Elimination of the Retiree Drug Subsidy Deduction?

In response to the increased cost of providing retiree prescription drug coverage, some employers are considering eliminating their retiree prescription drug benefits. If an employer decides to eliminate these benefits, retirees who were previously covered by the employer's prescription drug plan would be eligible to enroll for prescription drug coverage under Medicare Part D.

Although Medicare Part D has historically had a gap in coverage (the donut hole) that made the program a much more expensive option for retirees compared to coverage under an employer's prescription drug plan, the PPACA established a system to eliminate this gap. Essentially, before the PPACA, the program provided expansive benefits for the initial $2,830 in prescription drug costs and for prescription drug costs above $6,440, but required enrollees to bear the full cost of prescription drugs within the donut hole (between $2,830 and $6,440). However, the PPACA provides for enhanced Medicare Part D coverage, which progressively narrows this gap between years 2011 and 2020, thus making Medicare Part D a more financially viable alternative to employer-provided prescription drug coverage. This enhanced Medicare Part D coverage provides many employers with an additional reason to consider eliminating retiree drug benefits.

By terminating its retiree drug benefits, an employer would avoid the increased tax liability and current accounting hit to earnings. However, there are practical and legal concerns that an employer should consider before eliminating retiree prescription drug coverage.

Legal Concerns

Employers should consider the probability of litigation when terminating a retiree drug plan. Under the Employee Retirement Income and Security Act of 1974, as amended (ERISA), lawsuits can be filed by disgruntled plan participants or groups of retirees. The likelihood of success for these lawsuits depends on what types of promises have been made to retirees and whether the employer has adequately reserved in plan documents the right to terminate its retiree prescription drug plan. Lawsuits challenging retiree benefit changes are generally not successful where the company has been careful to reserve the right to amend or terminate health benefits, and retirees have not been lead to believe through written plan communications and documents that their retiree medical benefits are vested. Lawsuits about termination of retiree prescription drug benefits can be more complicated where there are union contracts (particularly contracts that are unclear about the scope of retiree coverage) or where the company has represented that retiree medical benefits are guaranteed for the life of the retiree.

To evaluate litigation risks, employers considering eliminating retiree prescription drug coverage should carefully review the wording of their benefit plan materials, union contracts, employee/retiree communications and other applicable documents.

Other Practical Concerns

In addition to legal concerns, employers considering eliminating retiree prescription drug coverage should consider the likelihood of negative reactions from retirees. Termination of retiree prescription drug coverage may also result in negative press for the company. In anticipation of these negative responses, employers that decide to eliminate retiree prescription drug coverage should be prepared by creating written materials (*e.g.*, participant mailings, call center scripts, press kits) that clearly describe the mechanics of and reasons for the change, and by providing retirees with assistance in timely electing drug coverage under Medicare Part D.

Next Steps for Employers

Employers that provide retiree prescription drug coverage should analyze the increased future tax liability and the current accounting charges necessary to retain retiree prescription drug coverage, and evaluate the practical and legal risks of eliminating this benefit. Employers that decide to retain retiree prescription drug benefits should ensure they incorporate the future tax liability of these benefits into their current and projected earnings. Employers that decide to eliminate retiree drug benefits should prepare for the likely negative responses and potential litigation associated with that decision.

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