The Unintended Consequences of Eliminating the
Tax Exclusion for the Medicare Retiree Drug Subsidy (RDS)
Prepared by Towers Watson for the Partnership for Health Care Reform
March 12, 2010

Background -- The Medicare Modernization Act of 2003 created a Part D prescription drug benefit. Generous federal subsidies were provided for commercial prescription drug plans (PDPs). A somewhat lower -- but tax-free -- Retiree Drug Subsidy (RDS) was provided to employers who provide retiree drug benefits at least equivalent to Part D.

President Obama's proposed reform, like the reform bills that have passed the House and Senate, would continue the RDS subsidy to employer plans, but would subject the RDS to corporate income tax.

For-profit employers who provide prescription drug benefits to Medicare retirees currently receive a non-taxable RDS subsidy averaging $665 per plan member. If taxed, there would be a large and immediate impact on company earnings. Many would withdraw their support for retiree medical benefits.

Impact on Employers – There were more than 3500 employers approved to receive the RDS in 2008, of which a significant number were for-profit employers eligible for the tax exclusion.[1] For employers paying corporate income tax, loss of the RDS tax exclusion means:

- Additional taxes of $233 per year for each post-65 retiree and each spouse in 2011.[2]
- The immediate reduction to earnings reported in 2010 could be $2,800 per RDS recipient, reflecting future costs to the employer.
- Generally Accepted Accounting Practices require immediate recognition of a law's effect on future income – even if the law does not go into effect for several years.

1 CMS, 2008 RDS Plan Sponsor List as of 10/6/2008.

2 The estimates presented in this brief draw heavily from the 2009 Medicare Trustees Report and "Implications of Health Care Reform for Retiree Health Benefits," by Paul Fronstin, Employee Benefit Research Institute, January, 2010, no. 338. The estimates assume a corporate tax rate of 35 percent.

- For a large employer with 25,000 current RDS retirees and dependents, this would be a hit of $70 million in 2010, even if the law is not yet effective.[3]

- The national total would be nearly $14 billion if these same assumptions were used to project the reduction to earnings for all for-profit employers receiving RDS subsidy payments.

Impact on Retirees – Loss of employer support for retiree prescription drug plans could adversely affect 5 million retirees in retiree medical plans sponsored by for-profit employers and receiving an RDS subsidy.[4]

.

- Employer plans generally provide much better protection than the standard Medicare PDP benefit, but these employers are likely to drop their plans in favor of commercial PDP plans because of the new law's impact on earnings.

- The standard PDP plan design requires out-of-pocket expense of up to $4,550 before reaching the "catastrophic" level, after which Part D pays 95% of drug costs.

- The additional out-of-pocket costs in PDP plans could be thousands of dollars each year for many retirees, even if the employer pays the Medicare Part D premium.

- Retirees may receive employer assistance with Part D premiums averaging $35-37 per month for standard coverage in 2010.

Impact on Government – Additional costs would result for government:

- Medicare provides higher subsidies for commercial PDPs than for employer plans.

- Employer contributions toward the premium for a PDP remain deductible as a business expense.

3 This assumes that the employer plan expects to receive an RDS subsidy indefinitely for current and future retirees.

4 Six million retirees were in plans receiving a RDS subsidy in 2009, but some of these were in plans not sponsored by for-profit entities.

- The total government cost per Medicare enrollee will be almost twice as high for each enrollee that moves from an employer plan with an RDS subsidy to a standard PDP ($1,209 vs. $665 in 2011).[5]

- If 5 million retirees in RDS plans were moved into commercial PDPs that received the higher subsidy, additional costs to government would be 2.7 billion per year.[6]

Conclusion -- The Medicare Modernization Act of 2003 placed the RDS subsidy high enough that, considering the tax exclusion, most employers have continued to provide prescription drug benefits to their Medicare retirees. Eliminating this RDS tax exclusion would encourage employers to drop their plans. Retirees would be forced out of relatively generous employer plans into less generous commercial Medicare Part D plans. Medicare costs would rise as millions of additional retirees enroll in commercial PDPs which receive higher subsidies. Employers, retirees and government would all be adversely affected.

5 Fronstin, January, 2010.

6 Not all employers would make this change immediately due to union agreements and other constraints, but over time if is likely that employers would seek to move away from the RDS when other arrangements such as commercial PDPs are more attractive.