

**Assessing the Coverage  
and Budgetary  
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**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.

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.

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.

## 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.

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

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<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."

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.