



Accounting for impact of health law provision eliminating tax deduction related to Medicare Part D subsidy

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The Patient Protection and Affordable Care Act (PPACA), signed into law today by President Barack Obama, includes a provision eliminating tax 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. Employers currently receiving the Part D subsidy will be required to make adjustments to deferred tax asset balances on their balance sheet in the period in which PPACA is signed into law, generally resulting in significant charges to tax expense in the income statement this quarter.

Background

The Medicare Prescription Drug, Improvement and Modernization Act (MMA), enacted in 2003, provided 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 currently are not taxed on the RDS payments they receive.

In response to MMA, the Financial Accounting Standards Board (FASB) issued FSP FAS 106-2, *Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003*. The FSP 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 was 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 PPACA

PPACA changes 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 change in tax treatment does 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, under PPACA, the deductible temporary difference and any related deferred tax asset on the employer's balance sheet 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 (that is, the date the bill is signed into law by President Obama). (The effective date under PPACA is tax years beginning after December 31, 2010. However, the House-passed health care reconciliation bill now under consideration in the Senate (H.R. 4872) would delay the effective date until tax years beginning after December 31, 2012. The reconciliation bill will require only a 51-vote majority to pass in the Senate.) This is true regardless of the effective date of the change in tax law (although the effective date would likely impact the amount of the change in the deferred tax asset, due the deductibility of the health care expenses incurred prior to the effective date). 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. PPACA effectively results in a new tax that employers will be required to pay on the federal subsidy received for retiree prescription drug benefits. The impact of the new tax will be recognized immediately in the income statement upon enactment of PPACA.

For many employers, the income statement impact can be estimated as 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 will be adversely affected in future periods by this change. For employers that have a full valuation allowance against their deferred tax assets under ASC 740, PPACA will have no immediate net financial statement impact related to the change in tax law.

Plan changes before enactment

Some employers have made plan changes that would disqualify them from receiving subsidy payments in the future, such as reducing benefits so that they are no longer actuarially equivalent to the benefits under Medicare Part D.

A change such as reducing benefits should 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 was adopted by the employer before enactment of PPACA.

Measuring the impact

To properly reflect the change in deferred taxes described above, employers need to determine the appropriate adjustment to the deferred tax accounts as of the date of enactment of PPACA. Since the deferred tax balance is derived from the pre-tax benefit obligation balance, questions have arisen as to whether an interim remeasurement of the benefit plan (both the benefit obligation and the fair value of any plan assets) is necessary as of the enactment date.

Generally, the benefit plan accounting guidance requires plan measurements annually, and requires interim remeasurements if a significant event occurs. ASC 715 does not specifically define what a significant event is, but generally implies it is an event that has a significant direct impact on the plan. Examples include significant plan amendments, curtailments, and settlements.

The change in the tax deductibility of future benefit payments resulting from PPACA does not have any direct impact on the benefit obligations and expense for ASC 715 accounting purposes, since these amounts

are already on a pre-tax basis. Thus, in our view, the change in taxability resulting from PPACA does not represent a significant event requiring interim remeasurement of the plan for ASC 715 accounting purposes. However, some employers may consider that other aspects of the changes required by PPACA will significantly change the benefit obligation, in which case an interim remeasurement would be appropriate.

In any case, to comply with the tax accounting guidance and adjust the deferred tax accounts at the enactment date, employers may need to obtain an updated estimate of the plan benefit obligation as of the date of enactment.

Observations: After enactment of PPACA, plan obligations and tax expense will no longer need to be determined following the "with" and "without" subsidy basis outlined in FSP FAS 106-2 par. 19. The unrecognized gain/loss and prior service cost components of AOCI previously tracked on a "without subsidy" basis will no longer be used in determining the postretirement benefit expense for income tax purposes. Employers and their actuaries who previously maintained records following the "with" and "without" subsidy basis will no longer need to do so.

Illustrating the income statement impact

Before enactment of MMA in 2003, a company had an unfunded retiree health plan with a benefit obligation of \$100. Assuming a 40-percent tax rate, the company would also have recognized a deferred tax asset of \$40 relating to the \$100 deductible temporary difference. After enactment of MMA, when taking into consideration the impact of expected subsidies, the benefit obligation is reduced to \$70. However, since the subsidy is not taxable, the temporary difference of \$40 remains.

	Benefit obligation	Deferred tax asset
Status "without" subsidy	\$100	\$40
Impact of subsidy	30	0
Status "with" subsidy	70	40

Assume that immediately before PPACA (as well as the pending reconciliation bill) was signed into law, the employer's benefit obligation remains \$70, and the deferred tax asset remains \$40. After enactment, the benefit obligation will remain \$70, but the deductible temporary difference will decrease from \$100 to \$75 (note that it does not decrease to \$70 because under the reconciliation bill the subsidy is still tax advantaged until tax years beginning after December 31, 2012). As a result, the deferred tax asset will be reduced by the \$25 difference times the company's tax rate, or \$10, through a charge to the income tax provision in continuing operations in the income statement.

	Benefit obligation	Deferred tax asset
Status "with" subsidy under current tax law	\$70	\$40
Reduction of deductible temporary difference through income statement	0	10
Status "with" subsidy under PPACA as amended	70	30

Thus, with today's enactment of PPACA, the employer will record the following entry:

Dr. Income tax expense	10	
Cr. Deferred tax asset		10

For more information on this WNTS Insight, please contact Ken Kuykendall at (312) 298-2546 or o.k.kuykendall@us.pwc.com, Ed Abahoonie at (973) 236-4448 or edward.abahoonie@us.pwc.com, or Jennifer Spang at (973) 236-4757 or jennifer.a.spang@us.pwc.com.

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