

# *HRS Insight*

## *Human Resource Services*

HRS Insight 11/16  
August 15, 2011

### VEBA prefunding can preserve tax advantages of Medicare subsidy

By using a VEBA, some plan sponsors may be able to preserve the tax deductibility of some or all of the future retiree prescription drug benefit payments impacted by PPACA.

*Authored by: Ken Stoler, Martin Hill*

#### *Background*

The Patient Protection and Affordable Care Act (PPACA) effectively changed the tax treatment of the federal Medicare Part D retiree prescription drug subsidies ("Medicare subsidies") paid to many sponsors of retiree health benefit plans. Under PPACA, for tax years beginning after December 31, 2012, a plan sponsor's tax deduction for retiree health benefit payments is to be reduced by the amount of any Medicare subsidies received. This change in taxation caused many plan sponsors to take a one-time financial statement charge in tax expense for the loss of the deduction in the first quarter of 2010. See HRS Insight 10/08 for details.

By using a VEBA, some plan sponsors may be able to preserve the tax deductibility of some or all of the future retiree prescription drug benefit payments impacted by PPACA. Specifically, to the extent future retiree prescription drug benefit payments are prefunded in a VEBA during tax years beginning before December 31, 2012, sponsors can still take an accelerated tax deduction for the full amount of those future payments. This tax planning strategy also results in an income tax benefit in the income statement. In practice, it may not be feasible to prefund enough to preserve the tax deductibility of all future retiree drug benefit payments due to lack of available cash and to maximum limits on deductions for prefunding retiree medical benefits under the Internal Revenue Code.

#### *How It Works*

By prefunding future retiree benefit payments in a VEBA, plan sponsors can take accelerated tax deductions for future benefit payments in the tax year in which the



---

funds are contributed. When benefit payments are eventually made from VEBA funds, the sponsor does not take a tax deduction since the deduction was taken when the funds were contributed. Thus, the PPACA provision that reduces the tax deductibility of retiree drug benefit payments made after 2012 does not directly impact payments made from a VEBA since the sponsor will have already taken the deduction when the VEBA was funded.

If sufficient funds already exist in a reserve that has been established within the VEBA to pay future retiree medical expenses generally, **this strategy may be implemented without requiring an additional cash contribution.** Alternatively, plan sponsors can implement this strategy by contributing new funds into a VEBA prior to the 2013 tax year. If contributing new funds to fund future payments to nonunion employees, sponsors will need to consider the fact that future investment earnings generated by these contributions will be taxable as "unrelated business taxable income". This cost will need to be considered as part of the feasibility analysis for implementing the strategy.

In either case, sufficient procedures and controls should be implemented to ensure and document that post-2012 benefit payments subject to PPACA restrictions are paid from pre-2013 VEBA reserves rather than from company assets. Further, as discussed below, existing funds within a VEBA retiree medical reserve intended to cover post-2012 benefit payments impacted by PPACA should be currently earmarked in order to reflect the future tax benefit in current period financial statements.

*Observation: Under the Internal Revenue Code, amounts that are otherwise allowable as deductions that are allocable to tax-exempt income are not deductible. PPACA removed a special exception that deemed tax-free Medicare subsidies as not constituting tax-exempt income for this purpose. Therefore, beginning in 2013, the benefit payments that are "allocable" to Medicare subsidies will no longer be deductible to the extent of the actual subsidies received. The specific prescription drug benefit payments for which the plan sponsor will be receiving the Medicare subsidy are "allocable" to the Medicare subsidy for this purpose. As noted above, sufficient procedures and controls should be implemented to ensure and document that pre-2013 VEBA amounts are to be used to cover these specific post-2012 prescription drug payments in order to minimize post-2012 loss of deductibility.*

## **Accounting Impact**

In 2010 when PPACA was enacted, many companies were required to write down existing deferred tax assets based on the amounts of future deductions that would be lost under the new rules. These write-downs resulted in immediate charges to tax expense, thus directly reducing net income for the period. These charges were significant for many companies, and represented charges of up to \$1 billion for some companies.

If this VEBA pre-funding strategy is implemented, it will have a current accounting impact. Typically when a contribution is made to a retirement plan, the current tax deduction will reduce a previously established deferred tax asset (DTA). However,

under this pre-funding strategy, the current tax deduction that results is reflected via a reduction in the current taxes payable balance, with both a corresponding reduction in an existing DTA *and* an income tax benefit in the income statement.

As discussed above, another strategy may involve earmarking funds that are currently held in a VEBA (i.e., no current cash contribution is required). To the extent the earmarked funds are sufficient to cover those benefit payments whose future deductibility is potentially impacted by PPACA, the entity will receive a tax benefit to the income statement similar to the benefit described above. Additionally, the deferred tax asset will be increased accordingly, with a corresponding tax benefit recognized in the income statement.

*Observation: Whether or not existing VEBA funds are used to execute this tax strategy, after implementation there will be an ongoing difference between the balance sheet liability and the deductible temporary difference, as there was prior to PPACA. Therefore, in order to appropriately determine the DTA and related tax expense, plan sponsors will once again need to keep track of their retiree medical financials on a "with" and "without" subsidy basis<sup>1</sup>.*

## Illustration

Prior to PPACA, a company had a retiree health plan with an unfunded benefit obligation of \$100 excluding the effect of expected Medicare subsidies after 2012, and \$75 including the effect. Assuming a 40% tax rate, the DTA was \$40 relating to the \$100 deductible temporary difference. Immediately after PPACA, the deductible temporary difference was reduced to \$75, resulting in a \$30 DTA. The \$10 DTA reduction was recognized in tax expense in 2010.

Prior to 2013, the company makes a \$50 contribution to a retiree medical VEBA. The \$50 equals the total unfunded benefit obligation associated with prescription drug benefit costs for Medicare-eligible retirees (excluding the effects of the Medicare subsidies), and the VEBA funds are earmarked for paying such costs. This contribution reduces the company's balance sheet liability by \$50, entitling the company to an immediate tax deduction of \$50, thus reducing taxes payable by \$20. While the balance sheet liability is reduced by \$50, the deductible temporary difference is only reduced by \$25, since the VEBA contribution is earmarked for expected payments that would not have been tax deductible and for which the DTA was previously written down in 2010. This reduces the DTA by \$10.

	Before PPACA	After PPACA	After Contrib.
<i>OPEB Liability on balance sheet</i>	\$75	\$75	\$25
<i>Deductible temporary difference</i>	100	75	50
<i>DTA</i>	40	30	20
<i>P&amp;L impact</i>		10	-10

<sup>1</sup> This treatment is discussed in ASC 740-10-55-57

The associated journal entries are: Debit tax payable \$20, Credit DTA \$10, Credit tax expense \$10.

*Observation: In this example, the P&L tax benefit of \$10 equals the \$10 expense taken in 2010 as a result of PPACA. A lesser amount would be recognized in income to the extent the full \$50 is not contributed to the VEBA.*

The same \$10 P&L tax benefit could be achieved if \$50 in existing retiree VEBA funds is earmarked for prescription drug benefit costs for Medicare-eligible retirees. Assume the same facts as above and assume the \$100 unfunded benefit obligation is attributable to \$150 APBO (excluding Medicare subsidies) and \$50 in VEBA assets. If the existing VEBA funds are subsequently earmarked, the deductible temporary difference will increase from \$75 back to the \$100, and the DTA will increase from \$30 to \$40.

	Before PPACA	After PPACA	After Contrib.
<i>OPEB Liability on balance sheet</i>	\$75	\$75	\$75
<i>Deductible temporary difference</i>	100	75	100
<i>DTA</i>	40	30	40
<i>P&amp;L impact</i>		10	-10

The associated journal entries are: Debit DTA \$10, Credit tax expense \$10.

*Observation: In this second scenario, earmarking the existing VEBA funds effectively restores the DTA to pre-PPACA levels, as well as enables the company to take the \$10 in P&L tax benefit. The clear advantage is that the same results can be achieved as in the first scenario without requiring a cash contribution to the VEBA.*

## *Benefits of the Strategy*

There are many advantages of this tax strategy:

- It enables plan sponsors to accelerate the tax deduction and to take a current period P&L tax benefit.
- It reduces the balance sheet liability associated with the retiree medical benefit plan and reduces ongoing ASC 715-60 expense through lower interest cost and expected return on assets.
- It does not require a change in benefit levels or benefit arrangements, other than funding.
- It provides added benefit security to plan participants.

## *Risks and Limitations of the Strategy*

This strategy also carries certain risks and limitations.

- For retiree medical plans that are currently unfunded, the strategy may require a significant cash contribution from the plan sponsor to preserve the entire tax deduction impacted by PPACA.
- To the extent the strategy is applied to non-union retiree benefits, the plan sponsor will be subject to actuarial limits on amounts that may be contributed to the VEBA and deducted each year prior to the 2013 effective date. (This annual deduction limitation will tend to be higher to the extent the non-union retiree medical obligation is attributable to current retirees rather than active employees.) Further, investment income attributable to reserves for nonunion retiree benefits will be currently taxed each year.
- Funds that are committed to a VEBA cannot revert back to the plan sponsor.
- Future legislative changes could occur that would adversely impact this tax strategy. It is possible that any changes could apply retroactively.

## *How PwC Can Help*

Plan sponsors interested in pursuing this strategy should consider performing a thorough feasibility analysis. This analysis should assess the cash, administrative, and operational requirements associated with implementing the strategy and weigh benefits against risks. PwC has considerable expertise in the accounting, tax, and operational issues related to funding retiree medical benefits. Please contact one of the individuals listed below or your local engagement partner for further information on how PwC can help.

*For more information, please do not hesitate to contact your local PwC professional:*

<i>Charlie Yovino</i>	<i>(678) 419-1330</i>	<i>Atlanta, GA</i>
	<i>(704) 344-7739</i>	<i>Charlotte, NC</i>
<i>Ed Donovan</i>	<i>(617) 530-4722</i>	<i>Boston, MA</i>
	<i>(646) 471-8855</i>	<i>New York Metro</i>
<i>Matthew Cowell</i>	<i>(617) 530-5694</i>	<i>Boston, MA</i>
<i>Pat Meyer</i>	<i>(312) 298-6229</i>	<i>Chicago, IL</i>
<i>Jack Abraham</i>	<i>(312) 298-2164</i>	<i>Chicago, IL</i>
<i>Paul Perry</i>	<i>(312) 298-3157</i>	<i>Chicago, IL</i>
<i>Terry Richardson</i>	<i>(312) 298-3717</i>	<i>Chicago, IL</i>
		<i>Kansas City, MO</i>
		<i>St. Louis, MO</i>
<i>Cindy Fraterrigo</i>	<i>(312) 298-4320</i>	<i>Chicago, IL</i>
<i>Brandon Yerre</i>	<i>(214) 999-1406</i>	<i>Dallas, TX</i>
<i>Theresa Gee</i>	<i>(312) 298-4700</i>	<i>Detroit, MI</i>
<i>Todd Hoffman</i>	<i>(713) 356-8440</i>	<i>Houston, TX</i>

<i>John Caplan</i>	<i>(646) 471-3646</i>	<i>New York Metro</i>
<i>Scott Olsen</i>	<i>(646) 471-0651</i>	<i>New York Metro</i>
<i>Bruce Clouser</i>	<i>(267) 330-3194</i>	<i>Philadelphia, PA</i>
<i>Bill Dunn</i>	<i>(267) 330-6105</i>	<i>Philadelphia, PA</i>
<i>Amy Lynn Flood</i>	<i>(267) 330-6247</i>	<i>Philadelphia, PA</i>
<i>Sandra Hunt</i>	<i>(415) 498-5365</i>	<i>San Francisco, CA</i>
<i>Julie Rumberger</i>	<i>(408) 817-4460</i>	<i>San Francisco, CA</i>
		<i>San Jose, CA</i>
<i>Scott Pollak</i>	<i>(408) 817-7446</i>	<i>San Jose, CA</i>
<i>Jeff Davis</i>	<i>(202) 414-1857</i>	<i>Washington, DC</i>
<i>Nik Shah</i>	<i>(202) 918-1208</i>	<i>Washington, DC</i>

This document is for general information purposes only, and should not be used as a substitute for consultation with professional advisors.

SOLICITATION

© 2011 PricewaterhouseCoopers LLP. All rights reserved. In this document, "PwC" refers to PricewaterhouseCoopers LLP, a Delaware limited liability partnership, which is a member firm of PricewaterhouseCoopers International Limited, each member firm of which is a separate legal entity.