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Growing Your Business™

Volume 58 . 2008

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Proactive planning
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Growing Your Business is published by the Private Company Services (PCS) practice of PricewaterhouseCoopers. It is focused on providing privately owned business owners and management with a point of view, guidance and insights on issues affecting their businesses and personal wealth.

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As employee healthcare costs continue to rise, employers need new solutions. A Total Health Management benefits strategy can help your company combat the rising costs of healthcare while improving employee health and productivity.

Getting a grip on employee healthcare costs

Healthcare costs are high—and they continue to rise at a much faster rate than inflation. Costs per active employee¹ have risen at a compounded annual growth rate of approximately 6 percent per year since 2004, with a cost per active employee of \$7,932 in 2007. And minor changes in plan design and shifting contributions aren't doing enough to keep costs down for employers.

“Most companies have now done just about as much as is possible to share costs with employees,” says Aron Minken, a New York-based director with PricewaterhouseCoopers' Human Resource Services practice. “Unless employers and employees take a more active role in addressing the root causes of most non-discretionary costs, there is almost no hope of stemming what has become, under the current system, an untenably expensive proposition for both companies and their employees.”

One way to take control is to apply a Total Health Management (THM) strategy to your company's health benefits program. A THM benefits strategy can help your company combat the rising costs of healthcare while improving employee health and productivity through targeted, strategic and value-added interventions.

A foundation built on consumerism

The objective of any corporate healthcare program is to provide employees with quality benefits at the most reasonable price through programs that are sustainable over time and promote a healthier work environment.

Current systems have failed to tie the right financial incentives to the behaviors that guide employees and providers to make the healthiest, most cost-effective choices about care. Changing plan design can be critical to healthcare cost containment, but to really make a difference, organizations need to execute a strategy that effects a change in mindset, behavior and ultimately culture.

¹ Saratoga 2008/2009 Human Capital Effectiveness Report. Healthcare costs include medical, prescription drug, dental and employee assistance program (EAP) fees or premiums.

Figure 1: Potential elements of the consumerism model



Participants generally have little appreciation of the value of the benefits provided to them, little understanding of the total cost of the care they receive, and little at stake for over-utilizing their benefits. The consumerism element of THM encourages individual involvement in healthcare purchasing behaviors by providing incentives for employees along with the educational tools and support needed to make appropriate and informed decisions on how best to allocate their healthcare spend (Figure 1).

Consumerism is not a single product, but a strategic process that involves constant evaluation of the programs, tools and techniques made available to the consumers of healthcare. Consumerism-based programs can:

- contain a Health Savings Account that ties to a high-deductible insurance plan;
- cover health screenings and other preventive care at 100 percent;
- reward employees and their families for using tools and modifying behavior to improve their health;
- contain decision-making tools for participants.

How it works

By providing incentives for healthy behavior, THM can help to increase workplace productivity and reduce paid time off. THM initiatives make employees part of the solution and send a message that the company cares about employee health, safety and well-being by adopting a corporate health excellence framework and by demonstrating a commitment to a culture of health.

Adopting a corporate health excellence framework. A sustainable health strategy should be built on the lessons learned from other business-improvement initiatives, such as safety and quality programs. Just as in those cases, activities and programs alone will not necessarily lead to meaningful or lasting transformation. Organizations must adopt a business-appropriate, disciplined approach that is both incremental and comprehensive. A sustainable healthcare strategy must:

- deploy an integrated data platform to measure, assess, prioritize, regionalize and personalize the overall health strategy;
- facilitate seamless collaboration in the integration of internal and external resources to support health programs;
- continually identify performance gaps and realign programs, processes and policies to deliver measurable progress.

A commitment to a culture of health. “Total health management requires the creation of a corporate culture of health that encourages employees to take an active interest in managing their own health and making the right

choices,” says Hollie Bialek, a manager in PricewaterhouseCoopers’ New York Human Resource Services practice. Helping employees and their dependents take better care of themselves and instilling employee health/wellness accountability is essential to reducing the prevalence, severity, and cost of chronic conditions such as diabetes, cancer and heart disease. A commitment to a culture of health also includes:

- offering tools and support for personal health management and preventing illness before it starts;
- investing more front-end dollars to create and reward a culture of health, in order to achieve long-term gains through reduced spending on back-end treatment;
- providing the support of senior leadership, who can communicate the linkage between employee health, performance and business goals.

Reward-based strategies

One keystone of THM is rewarding members for using tools and modifying behavior. To generate interest, monetary programs work best. Rewards are combined with communication strategies to drive employee participation in programs. Then, as programs become more familiar to employees, it becomes easier to tie incentives to benefit contributions. Companies must set reward parameters that keep employees having “skin in the game,” but employees must still perceive they are being rewarded for healthy behavior.

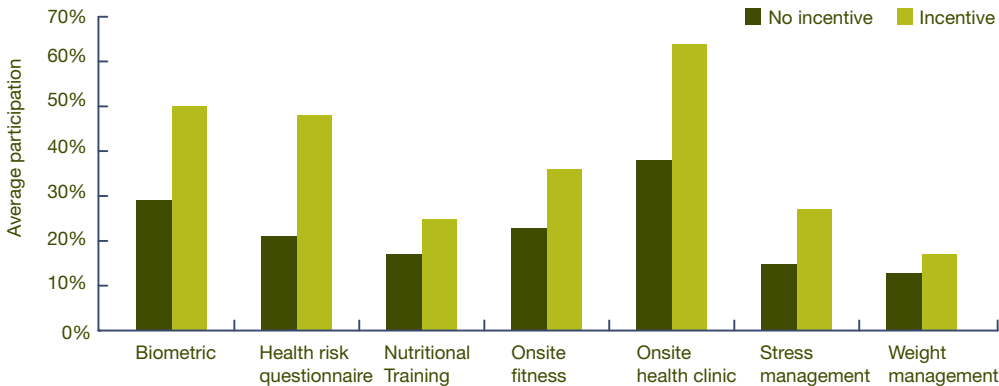
In June 2008, PricewaterhouseCoopers conducted the Health and Wellness Touchstone Survey, in which 561 companies were asked about their healthcare plans. The survey found that of the 69 percent of companies that offer wellness programs, less than 30 percent of eligible individuals participate. What drives participation? Incentives such as cash or gift cards of up to \$199 or annual premium incentives of up to \$500 do so significantly. For example, employers offering an incentive to complete a Health Risk Assessment increased participation by 129 percent compared to those employers not offering an incentive. For all wellness programs, on average, employers that offer an incentive increase participation by 69 percent (Figures 2 and 3).

Examples of reward-based initiatives include:

- On-site, vendor-provided health screenings to include health risk assessments, body mass index measurements and health improvement recommendations. Such screenings typically cost about a third of a physical exam.
- Weight control programs, such as at-work programs, local meeting coupons, online programs and monthly reimbursement of employee costs of participation in a weight-loss program of their choice.
- Physical fitness programs, such as (1) gym memberships with negotiated group discounts and employee reimbursements subject to usage/ progress reports, and (2) workplace wellness programs, including health and wellness seminars, walking programs and injury prevention programs.
- Stress management programs
- Cash rewards for wellness assessments, program enrollment and milestone achievement.

Figure 2: Wellness programs with and without incentive programs

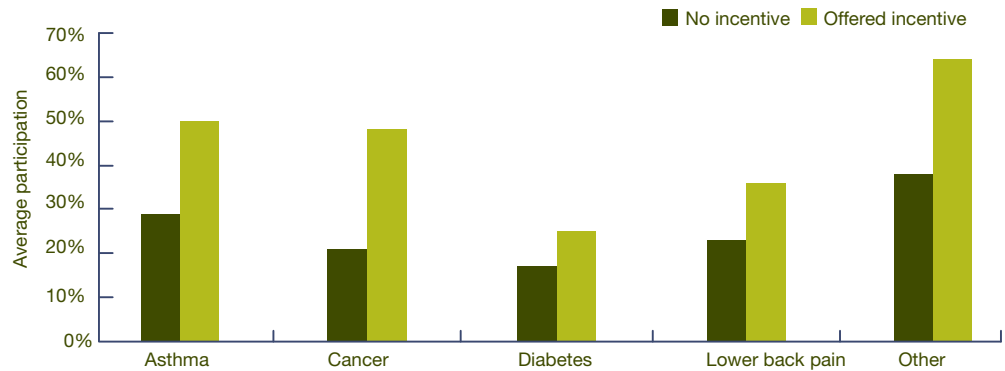
Incentives drive participation



Source: 2008 PricewaterhouseCoopers’ Health and Wellness Touchstone Survey

Figure 3: Disease management programs with and without incentives

Incentives drive participation



Source: 2008 PricewaterhouseCoopers' Health and Wellness Touchstone Survey

Transparency required

THM programs arm employees with the information and incentives they need to take responsibility for their own health. The most critical success factor for THM is timely information: transparency in pricing and quality of care for both companies and patients.

“Technology is a key driver for transparency,” says Minken. “For example, companies can now quickly and easily see data from vendors showing exactly how money is being spent. That knowledge can then be leveraged into where companies should focus to improve employee health and the choices employees can make in obtaining care.”

Technology also provides a wide range of ways for employees to make better-informed choices. For example, the plans offered by one major healthcare company now offer patients a financial incentive to choose highly preferred physicians by providing information about physician performance and requiring lower co-pays for physicians who meet or exceed certain quality and efficiency measures.

Transparency also means educating employees about the effect that their choices have on their health and on healthcare costs. However, Minken points out that “many employees are of the belief that ‘I don’t want you getting into my personal life.’” Bialek notes that part of THM involves educating employees about the multiple ways in which their privacy is protected: “The Health Insurance Portability and Accountability Act (HIPAA) and other regulations now limit the information that employers can receive. Employees need to be reassured that employers get only aggregated data and no individual information.”

Getting started

Moving towards THM does not involve the expense many companies might think. “Large companies and their vendors have led the way and the costs of implementing a THM approach have fallen dramatically in recent years,” says Minken. “Smaller companies now have the ability to do it at low—or even no—cost.” For example, Bialek adds, “many insurance companies now include preventive care and related health risk assessments for free, whereas even five years ago these elements were not an option.”

However, what works for one company may not work for another. Effective incentives must be aligned with a company's unique demographic profile. Companies with a young employee base may focus on disease prevention, while those with an aging population may use incentives to target issues around chronic illness. "Each company will need to consider what's right for them and what they can afford. But even small steps can have an impact—the important thing is to determine which steps will have an impact and to take action accordingly," notes Minken.

"An employer cannot just implement a plan and expect results," Bialek explains. "First, there must be a strategy, followed by effective communication, education and incentives. The tone at the top is also critical. It is helpful when the top executive is the one sending out the communications. Also, a plan is unlikely to work if the company's executives aren't themselves following it. Employees will think, 'If you're not doing it yourself, why should anyone else do it?'" Bialek explains.

Consistent follow-up is also key. Says Minken: "A company can't do one initiative, then just move on to something else. Behavioral changes occur over the long-term. There must be effort, resources, and incentives to 'keep the pressure on' in order to effectively change behavior."

Total health management is not a quick fix. "The goal is to keep healthy people healthy, and help those with chronic problems become healthier," explains Bialek. "Companies will see costs change over time, though they should start to observe changes in employee decision-making sooner."

Realigning healthcare objectives, intentions and incentives

People often don't recognize that the culture you create at work has a significant effect on business results. Realigning the objectives, intentions and incentives between your company's employees and its healthcare program will enable your employees to take charge of their own health. The realignment can yield meaningful relief from the healthcare cost crisis—and improve your company's bottom line.

Potential elements of consumerism

- Transparency/"Skin in the Game"
 - High deductible health plans
 - Higher cost sharing
 - Health accounts (HSAs and HRAs)
- Behavioral incentives
 - Account based
 - Contribution based
 - Tiered benefits
- Education & Support
 - Decision support
 - Push technology
 - Health coaching
 - Shared decision making
- Performance-based networks
 - Evidence-based medicine
 - Quality & efficiency
- Population health management
 - Personal risk assessment
 - Wellness & prevention
 - Disease & case management
 - Integrated absence management
- Environmental assessment
- Communications & change management
 - Culture of health & well being
 - Consumerism education certification
 - Personal health financial planning
- Special markets/populations
- Community-based Initiatives

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In anticipation of the uncapping of employment taxes, businesses are discovering the benefits of establishing employee deferrals that are tax favorable to both business and individuals. Qualified allocation plans take up where nonqualified deferred compensation plans leave off.

How to maximize the opportunities of deferred compensation

Is it possible for a partnership or corporation to continue to spend less every year while at the same time increasing employees' retirement savings, security and strategic tax planning opportunities?

"Absolutely," says Jack Abraham, principal with PricewaterhouseCoopers LLP, whose day-to-day activities in recent years revolve around helping firms do just that. And, with the anticipation that the cap on employment taxes (FICA) is likely to be removed (some think as soon as 2009), he doesn't foresee much personal vacation time in his future, as the opportunity for client tax-efficient savings becomes significantly more important.

The problem: In the current environment, businesses tend to have inefficient deferred compensation arrangements for executives and other employees. In these arrangements the executives forgo current earnings and the cash effectively becomes a loan to the company. The company, in turn, invests the forgone earnings and does not receive a corporate tax deduction until the funds are distributed to the employees (often times years later upon retirement). Additionally, the company pays corporate income taxes on the earnings and both the company and employee are subject to FICA tax at the time of the deferral. Not only does the typical *nonqualified deferred compensation* plan subject the company *and* its employees to unfavorable tax consequences, the employees risk losing their deferred savings in the event of bankruptcy, and the business is required to comply with complex IRS section 409A rules on deferred compensation.

The solution: A Tax Qualified Supplemental Executive Retirement Plan (TQS). This type of plan enables receipt of "qualified allocations" of compensation, held in a qualified trust separate and distinct from the employer. The advantages:

- exempts both employer and employee from FICA tax;
- enables the employer to take an immediate tax deduction for the amount deferred, while deferring income recognition to employees until receipt;
- eliminates any state income tax in certain states;
- secures "qualified allocations" of compensation from creditors.

“There is a huge value in deferring taxation until retirement, but the other benefit that is often overlooked is that if a *qualified allocation* program is set up properly, the employee can roll over any distribution amounts into an IRA, which allows employees to strategically time recognition of the deferral into taxable income,” says Abraham.

A corporation or partnership could benefit from essentially a one-time expense of instituting a TQS plan if it meets the following criteria:

- desires to save more cash now and in the future;
- currently has compensation deferrals going into a nonqualified arrangement;
- employees/partners are concerned about losing their savings to bankruptcy or situations with similar consequences.

How did we get here?

The broad-based movement to secured tax-favorable qualified allocation compensation plans has been driven by three factors over the past decade:

- The unfavorable regulatory environment for nonqualified deferred compensation programs (IRC section 409A rules) put in place after a series of the world’s largest Chapter 11 bankruptcy filings hit in 2001 and 2002 for Enron and Worldcom, in which a few executives retained their wealth while employees lost all of their deferred compensation savings.
- The Tax Act in 2002–2003 liberalized the rules around qualified plans and essentially doubled the amount that can be put into these programs. Later, the Pension Protection Act of 2006 provided more flexibility in designing the investment programs (as opposed to a 401(k) plan, which offers more limited choices for individuals). “In a TQS plan, the investment committee may invest the money any way it sees fit and prudent, and the asset returns may be credited to the employee notional accounts,” says Abraham. “Individuals won’t be able to choose their investments, but they benefit from the investment knowledge of professional asset managers who may choose from a much larger pool of investment options than the 401(k) plan would allow.”
- The speed to bankruptcy we’ve seen in huge companies across all industries, from corporations to professional partnerships.

How one privately held business and its partners realized tremendous savings

Switching from a nonqualified deferral to a qualified allocation plan could benefit both public and private companies, but privately held businesses or partnerships tend to appreciate the impact of greater relative savings for their employees.

In general, the benefits of making the switch are as follows:

- the company can take a tax deduction at the time of the deferrals;
- neither the employer nor employee pays employment taxes (FICA) on the money contributed to the TQS plan;
- the earnings grow tax free;
- the savings in the qualified allocation plan is protected from creditors.

“For example, a major oil company realized about a \$100 million benefit from switching from an unqualified deferred compensation plan to a TQS plan... but because they spend that kind of money every day, the benefit was not as substantial to their bottom line,” says Abraham. “However, we did this for an increasingly profitable consulting firm, with \$2.5 million of deferrals over 10 years for each partner, times 60 partners. Eliminating 1.45 percent FICA tax for both the employer and the employee (2.9 percent in total) meant the firm no longer had to pay approximately \$150,000 in FICA tax every year.

“If the cap on FICA taxes is removed and increases to 15.3 percent of total compensation for both the employee and employer in total, the annual savings this consulting firm would receive on FICA taxes would go up from \$150,000 to roughly \$775,000. In addition, if the firm is earning a 10 percent return on a total of \$5 million contribution every year, paying a 40 percent effective tax rate on the earnings under an unqualified deferred compensation plan would mean it would have to pay an additional \$200,000 every year. With a qualified allocation plan, which pays no tax on the earnings, the total savings could therefore be as large as \$350,000 to \$975,000.” This doesn’t consider the acceleration of the corporate deduction on the deferred compensation.

Here’s what the savings looks like for the partners of this consulting firm assuming a 7 percent return every year:

Year 1: 7 percent of \$5 million or \$350,000
Year 2: 7 percent of \$10 million or \$700,000
Year 3: 7 percent of \$15 million or \$1,050,000
Year 4: 7 percent of \$20 million or \$1.4 million
Year 5: 7 percent of \$25 million or \$1.75 million

And, this benefit is secure.

To illustrate how the savings add up for both employer and employee, let's compare the difference between deferred compensation benefits of \$100,000 under each type of plan.

Non-qualified Deferred Compensation Plan

- Employer and employee must each pay FICA tax at \$1,500.
- The employer pays corporate tax on the annual earnings from the investment. For example, a 10 percent return on \$100,000 increases the amount available for withdrawal to \$110,000 after year one for the employee. If the employer's effective tax rate was 35 percent, the employer is left with \$106,500 after tax, but still owes the employee \$110,000. In year one, the employer is essentially funding an additional \$3,500 to keep pace with what they owe the employee. This amount is compounded annually.
- The employer has no control over timing of the corporate deduction. The employer does not receive an income tax deduction for the \$100,000 funded until the employee actually receives the money (typically 20-30 years later, upon retirement). In addition, if the employer has net operating losses at the time the employee decides to recognize the income, the company might never receive a tax benefit.
- The savings are not secured against creditors in the event of bankruptcy. Additionally, if the company goes bankrupt (and no benefit is paid), it cannot recoup the FICA tax liability.

TQS plan

- The employer can fund the \$100,000, take an immediate income tax deduction and pay no tax on interest growth. In year one, that would be \$3,500 of savings, and it would grow each year.
- Neither employer nor employee is subject to FICA tax—a savings of \$1,500 each in the year deferred.
- Any time after year one, the employees may leave the company and continue to defer income tax by rolling their account over to an IRA. In addition, the employees can take money out of the IRA in any way that is most effective for their tax planning situation without penalty after age 55. "There are minimum distributions you have to take after age 70, but they are so small they're not likely to affect your tax planning," notes Abraham.
- The money is held in a qualified trust which is separate and distinct from the employer and, therefore, secured from creditors.

Compliance and limitations

It's important to consult a qualified tax advisor before implementing a TQS plan, which is held in a pension trust. This is not to be mistaken for the kind of pensions associated with the liability of paying a fixed amount to an employee for life. Also, it is not subject to the complex 409A deferred compensation rules.

There are limits on the amount that you can put in the TQS plans and limits on when you can take your distribution from the plan. There are some administrative burdens that go along with maintaining a qualified allocation plan, such as filing and audit requirements for plans of certain sizes, but they are not likely to be much greater than what a business currently has. In addition, there has to be a minimum level of benefits that are going to the rank and file employees; however, most employers are already providing benefits at these minimum levels in other plans, so the additional cost of providing the additional benefit is usually relatively small.

Given the expectation that the FICA cap will be removed in 2009, there seems to be only an increasing upside of the qualified allocation plan. "The hurdle you have relative to the benefit is very small," says Abraham.

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The days of promises to cover “retiree healthcare for life” are over. However, abandoning retiree healthcare benefits entirely may not be in your company’s best interests. These benefits can be critical to hiring and sustaining the right mix of talent. Here is an approach to retiree healthcare based on four key principles that can help you achieve these goals without impacting your financial statements.

Strategies for providing retirees access to affordable health benefits

Retiree healthcare is one of the Top 10 healthcare issues facing executives and policy makers next year, according to PricewaterhouseCoopers' Health Research Institute. Older employees worry that healthcare after retirement will be at best unaffordable and at worst unavailable. Most executives agree that employers should help provide access to affordable retiree health benefits, but they no longer want to be expected to pay for it. As the cost of healthcare continues to increase and access to coverage wanes, a new approach is needed—and ever more urgently as the baby boomers head toward retirement.

Cause for concern

While Medicare provides at least partial health benefits for retirees age 65 or older, “more than three million retirees between the ages of 55 and 64 rely on employer-sponsored plans for their health insurance coverage... and more than a third of all people aged 65+ (about 11 million seniors) have supplemental coverage from an employer plan.”¹ Without those employer-sponsored retiree medical benefits, older employees may have difficulty finding affordable retiree medical coverage on their own, particularly prior to their eligibility for Medicare. According to Michael Thompson, a principal in PricewaterhouseCoopers' Human Resource Services advisory practice, “If a group of pre-65 retirees does not get coverage from employers and goes on the open market for individual health coverage, only about one-third of the group will be quoted standard rates. Another third will be quoted higher rates, and the final third may not get any coverage at all, primarily because of pre-existing medical conditions.”

To make matters worse, many individuals nearing retirement are inadequately prepared for and unaware of the issues they will face around their health security. Medicare remains the cornerstone of health security for most retirees, yet according to its Trustees, it is projected to be insolvent in about one decade unless there is serious intervention.

At the same time, the percentage of companies with more than 200 workers that offer retiree coverage dropped from 66 percent in 1988 to 33 percent by 2007, according to the annual Kaiser/HRET Employer Health Benefits Survey. And smaller companies are even less likely to offer retiree health benefits.

Access to healthcare during retirement also affects an employee's decision to leave or re-enter the workforce. Many employees who would like to either retire or begin phasing into retirement are remaining at work full-time simply

¹ Henry J. Kaiser Family Foundation, “The State of Retiree Health Benefits: Historical Trends and Future Uncertainties,” Patricia Neuman, Sc.D.

to retain employer-provided health benefits. “For example, a 60-year-old person with Type 2 diabetes can’t afford to retire; he or she runs the risk of not passing a medical exam,” according to Martin Hill, a director and actuary with PricewaterhouseCoopers’ Human Resource Services practice. “Over time, this can create a stagnating older work force, which makes it difficult to ensure the right mix of talent and, importantly, to recruit advanced hires.”

Limit costs or optimize talent pools?

Not surprisingly, employers are increasingly unable or unwilling to incur a retiree health expense and liability that cannot be sufficiently controlled. Companies that have provided retiree health benefits have begun to cap or eliminate those benefits, particularly for new hires.

Accounting rules have played a role in this shift. “Companies have reacted to the negative—and often hefty—impact of FAS 106 accounting for post-retirement health liabilities on their financial statements,” says Hill. “They have responded by continuously shifting more of the cost of retiree health coverage to their retirees. For some, it’s a matter of positioning themselves in case they eventually start reporting under GAAP (e.g., considering an IPO). For others, it’s the reputation of retiree medical plans—they’ve heard the horror stories about the crippling costs of retiree health and are hesitant to get in the game themselves.”

At the same time, attracting talent remains a top concern. “Some mid-career individuals will not accept a position unless they can be sure they can retire with adequate access to health benefits,” says Thompson, “and this will become an increasingly high-profile issue. Ten years ago, many companies were seeking to move towards a younger workforce. Now, companies are competing for an inadequate pool of seasoned employees. With 25 percent of the workforce approaching retirement age, that shortage will only increase and companies will need to find ways to attract and retain experienced talent. Providing retiree access to affordable health benefits provides a valued and valuable benefit and competitive advantage.”

A new paradigm

Clearly, companies need to rethink how they approach retiree healthcare. Companies will need to devise a strategy that addresses the health security needs of retirees while retaining their ability to control costs and manage their talent pool. A successful approach to retiree healthcare can be built upon the following four principles:

- ensure access and choice;
- integrate health security into retirement education and financial planning;
- consider integrating account-based defined contribution plans;
- enable stewardship of benefits.

Ensure access and choice

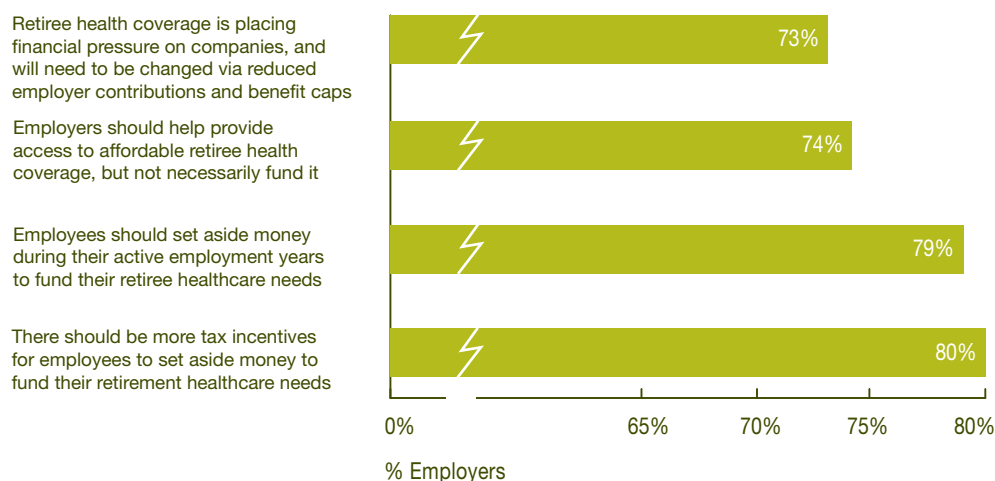
In a 2007 PricewaterhouseCoopers survey of executives’ views on retiree health coverage, 73 percent of respondents said that the coverage places financial pressure on companies, and that it will need to be changed via reduced employer contributions and benefit caps.

However, while employers want to get out—or stay out—of the healthcare business, they don’t want to walk away from the issue entirely. In another 2007 PricewaterhouseCoopers survey, employers showed strong support for assisting employees in managing their own retiree health and associated costs, with nearly 80 percent in support of providing savings account mechanisms,

tax incentives and access to coverage even if they do not fund it (see Figure 1). And, in a climate that focuses increasingly on wellness, employers want to encourage active employees to “invest” now in their futures with healthy lifestyle changes and sound financial decisions for retiree health coverage.

Figure 1: Employer views on retiree health

In describing your views about *retiree health coverage*, do you agree at least somewhat with the following statements?



Source: PricewaterhouseCoopers 2007 Management Barometer Survey

Thus, even as retirees assume more of the financial burden of coverage, a company can play a major role in facilitating access to coverage upon retirement as well as through second careers and phased retirement. To that end, companies should offer a range of choices to support various degrees of affordability and coverage.

Educate your employees

Generally speaking, employees do not appreciate the scope of the issues and financial needs related to retiree medical benefits. For example, workers typically do not realize how expensive retirement healthcare can be, particularly when one considers coverage before Medicare eligibility and the need for coverage for the rest of one’s life. Employees also do not save enough for retirement in general, and specifically not enough to provide adequate health coverage; financial planning tools rarely fully acknowledge the significant role of health expenditures during the retirement years. Numerous studies show that, given inadequate savings rates, Americans “will not be able to support a moderate lifestyle in their retirement years, let alone out-of-pocket healthcare costs and premiums....Some employees are retiring before they are eligible for Medicare, which requires even more savings.”² Moreover, lengthening lifespans mean an even bigger strain on inadequate savings.

Integrating health security education with general financial security education can be critical to the long-term well-being of employees. In addition, employees need the tools to make informed choices both while active and when retired. For example, retirees “need support comparable to what they were accustomed to receiving through a benefits representative. This practice will ensure that retirees use their contributions/accounts efficiently and are getting the coverage that meets their healthcare needs.”³

² “New Models for Retiree Healthcare,” National Business Group on Health, 2007.

³ Ibid.

Consider account-based defined contribution plans

The shift toward employee responsibility and away from company sponsorship can be viewed as analogous to the shift from company-sponsored retirement plans to individually-managed 401(k) and 403(b) plans. Employers can similarly consider the use of defined-contribution account structures, for example, Health Savings Accounts, VEBAs, and notional Retirement Health Accounts, to assist retirees with their long-term health security needs.

“Funding for retiree medical is always a challenge because there is no perfect account structure for tax-advantaged savings for retiree medical,” says Hill. “Each type of account structure has pros and cons. However, employers can examine strategies that utilize and potentially combine both funded and non-funded account structures.” Integrating traditional and non-traditional account structures for the retiree provides more predictability to the employer while enabling active retirees to visibly understand, assess and “own” their retiree health security issues (see Figure 2). Says Thompson: “As you think through what account structure will work for your company, you will need to determine how best to support employees in preparing for their retirement health security.”

Figure 2: Comparing approaches to retiree healthcare

Element	Traditional/defined benefit approach	Access only/defined contribution approach
Liability	Employer obligation with uncontrollable liability	No or defined employer obligation
Responsibility	Primarily company (little “employee ownership”)	Employee or employer/employee shared responsibility
Level of employee involvement	Minimal employee knowledge and engagement	Engaged and educated employee
Employee appreciation of benefit	Generally not considered part of “total rewards”	Considered as part of “total rewards”

Enable stewardship of the benefits

One of the keys to designing an effective strategy for retiree healthcare is to recognize the need for a longer time horizon, both because people may not be able to retire for many years and because the healthcare landscape will continue to change dramatically. We know Medicare can't stay the way it is. Moreover, companies themselves change, sometimes dramatically through mergers and acquisitions, industry restructurings and some even go out of business. As Thompson points out, "Who will keep track of the healthcare environment as it evolves? How will you keep your options current over time? Whatever strategy you put in place for today must be adaptable to changes that will occur tomorrow."

As a result, it can be helpful to engage a third party to steward and effectively update the program over time. Says Thompson, "Stewardship can optimize the choice and value of the retiree medical benefits over time and preserve the value of the benefits or funds that may have been accumulated over time."

Looking forward

As the cost of providing retiree health benefits continues to grow, providing affordable access to healthcare for older employees becomes more important for employers—and for their employees. By building a strategy based on the above principles, you can limit your financial exposure as an employer while still providing a valued benefit for older workers. In an environment of escalating costs and an unpredictable future, providing affordable healthcare access along with the right employee education can help you attract and retain valuable talent—and protect your bottom line.

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As the calendar year draws to a close, it's time to start thinking about 2008 tax returns. While there has been some tax-related legislation in the past year, it has been relatively minor; it's worthwhile to review some favorite tax-planning techniques.

A little planning goes a long way, and these strategies may help you better manage your 2008 tax liability.

With little new tax legislation passed ahead of the presidential election, 2008 year-end tax planning strategies for individuals remain relatively unchanged. Favorite techniques, such as deferring taxable income, accelerating tax deductions and rate shifting, still serve as the foundation of annual tax planning. However, individuals should be aware that the new president may introduce new legislation including tax rate increases which could alter the effectiveness of the following strategies.

Income-deferring strategies

- **Maximize tax-deferred savings.** Some simple moves in this area can help you take advantage of the time value of money by using pre-tax dollars for retirement saving. Examples include:
 - Contributing to your company retirement plan or 401(k). This reduces current year taxable income and allows an individual to grow their funds tax-free until withdrawing in retirement.
 - For self-employed individuals or those with supplemental income such as director's fees or consulting income, establishing a SEP-IRA provides an additional method for capturing the benefits of tax-deferral. SEP-IRAs allow for tax deductible contributions and ease of administration.
 - Invest in tax-deferred annuities or variable insurance products. These vehicles enable you to save after-tax dollars, but the earnings are not taxed until later or may never be subject to tax.
- **Capital loss harvesting.** A quick review of your investment portfolio can identify unrealized losses that could be used to offset capital gains or up to \$3,000 of ordinary income such as wages and interest. However, taxpayers should be aware of the "wash sale" rules that disallow losses on securities sold and then repurchased within 30 days of the sale.
- **Delay receipt of anticipated bonuses or incentive compensation until a future year.** Many new restrictions on this strategy have been legislated in recent years; however, deferral options still exist with advance planning.

Caution: Because the Alternative Minimum Tax (AMT) has a top marginal rate of 28 percent and disallows many common itemized deductions, such as taxes paid, the aforementioned strategies may not work for individuals subject to AMT. Please consult your tax advisor to determine the applicability of AMT to your tax situation and to develop a plan to optimize your deductions.

Accelerating deductions and expenses

Because taxpayers generally have flexibility in the timing of their payments, accelerating deductions is probably the easiest way to carry out a year-end tax strategy. For example:

- **Make year-end charitable contributions.** Charitable contributions provide an easy means for tax planning as the donor controls when and how much is donated. Individuals who can shift contributions into the current year will benefit from the time value of money. Additionally, those with highly-appreciated stock can receive a charitable deduction equal to the fair market value of the stock on the date of transfer without triggering additional capital gains tax if the securities have been held for at least a year.
- **Prepay state and local taxes and real estate taxes prior to year end.** By prepaying their 2008 fourth quarter estimated payments or 2008 balances due in December 2008, individuals can deduct these taxes on their 2008 tax returns rather than waiting a full year to deduct on their 2009 return. Individuals can also consider prepaying real estate taxes to achieve a similar benefit.

Rate-shifting strategies

For those taxpayers facing the top marginal tax bracket, the following income-shifting strategies may help reduce your overall level of tax:

- **Incorporate tax-exempt bonds into your investment strategy.** This strategy is best illustrated with an example. If you have a taxable bond paying 5 percent interest, after federal and state taxes of 40 percent, you're only netting 3 percent. However, if you can find a municipal bond paying 4 percent, then you have reduced your taxes and boosted your after-tax investment return. Since some tax-exempt bonds such as private activity bonds are subject to the AMT, you may need some extra planning from your investment advisor to avoid or minimize these bonds in your portfolio.
- **Shift to tax-favored investments.** At least until the laws are repealed following 2010 (or earlier should new legislation be introduced), certain dividends and long-term capital gain income are subject to a maximum rate of 15 percent, compared to 35 percent for ordinary income. Consider reallocating equity investments generating qualified dividends to your taxable portfolio while moving fixed income investments generating interest income to your tax-favored portfolio (i.e., 401(k) and IRA). *Caution: Given the recent presidential election, it is possible that new legislation could be introduced which could increase these tax rates.*
- **Transfer assets to taxpayers over the age of 18 in a lower income bracket.** The recent revision of the "kiddie tax" rules has substantially limited the benefit of transferring assets to those 18 or under. However, this is still a viable option for adult children provided they are not full-time students between the ages of 19 and 23 whose earned income does not provide one-half of their support.
- **Financing a child's education using a 529 plan.** 529 plans provide for tax-free growth provided the withdrawals are used for qualified educational expenses. Additional state tax benefits may be available depending on your location and choice of plan.

Other useful planning ideas

- **Convert nondeductible interest to deductible interest.** Though interest expense on personal auto loans, credit cards and some student loans is not tax deductible, interest on home equity loans and investment loans is tax deductible within certain limits. It is prudent tax planning to use cash to buy personal items, such as cars, boats, etc., and to use loans to purchase investments. This maximizes the amount that you can deduct on your return as interest expense while avoiding non-deductible personal interest.
- **Hybrid vehicle credit.** With the recent spike in gas prices, many individuals are considering the purchase of a hybrid vehicle. In this case, they should not overlook the hybrid vehicle credit. Consumers seeking the Alternative Motor Vehicle Credit created by the Energy Policy Act of 2005 may want to buy early, since full credit is only available for a limited time. As of October 2007, the hybrid vehicle credit can no longer be claimed on Toyota and Lexus models. Also, the credit phase-out period has begun for Honda vehicles, so while reduced credits are available in 2008, no credit will be allowed after 2008. The specific amount of the credit varies from model to model of eligible vehicle, so please check with your tax advisor before purchasing.
- **Wealth transfer planning.** With several tax relief provisions set to expire within the next three years and substantial volatility in the estate tax area, it is crucial for individuals to work with their attorney and tax advisor to ensure their estate plans are up to date. A comprehensive estate plan review ensures that your plan distributes your estate to your intended beneficiaries in a manner that minimizes taxes paid and maximizes the wealth transferred. Additionally, the repeal of the state death tax credit has led many states to introduce new legislation which substantially increases state estate taxes.
- **Consider non-deductible contributions to an IRA.** In 2010, the income restrictions on converting a traditional IRA to a Roth IRA will be removed, thus giving anyone the option to convert. Although taxes must still be paid on the amount of the conversion, the rules allow these taxes to be spread over 2 years. One of the benefits of a Roth IRA conversion includes tax-free withdrawals which can be a major advantage when an individual anticipates higher future tax rates. Additionally, individuals are not subject to required minimum distributions, so assets can grow tax-free for a longer period. Lastly, taxes paid on the conversion do not need to come from the retirement account essentially allowing an individual to “transfer” additional funds to tax-favored accounts.

While going through this year-end tax planning checklist, be sure your federal and state tax withholdings and estimated payments are sufficient to protect you from underpayment penalties. Individuals generally avoid estimated tax penalties by paying in at least 110 percent of the prior year tax, or 90 percent of what you expect your tax liability will be for 2008, whichever is less.

Finally, it's important to remember that new presidents often introduce new tax legislation that can alter the tax-planning landscape. Should tax rates change, the strategies best employed to manage your tax liability will also need to be adjusted. While the strategies discussed here remain the foundation of annual tax planning, they must always be considered within the context of the current, and possibly changing, tax environment.

The year in review: recent legislation affecting individuals

Economic Stimulus Act of 2008

In addition to the recovery rebates, or stimulus payments, paid to qualifying individuals, the Economic Stimulus Act of 2008 contains certain tax benefits for businesses including sole proprietors. Two provisions, addressing expensing and bonus depreciation of property, accelerate tax benefits for businesses that purchase qualifying property this year. The Act increases the maximum amount of annual property purchases that can be expensed to \$250,000 in 2008. Under the new provision, the total amount of qualifying property that can be purchased before the expensing limit reduces is increased; the previous total of \$510,000 is now \$800,000 for 2008. The Economic Stimulus Act also provides a 50 percent special depreciation allowance for qualifying property purchased in 2008. Additionally, the Act increases the total depreciation amount an individual can deduct for certain passenger automobiles used in business.

The Heroes Earnings Assistance and Relief Tax (HEART) Act

The Heroes Earnings Assistance and Relief Tax (HEART) Act, passed in May, includes a variety of tax cuts for military personnel and veterans, as well as incentives for civilian employers who hold jobs for or continue paying some salary to troops called to duty. The total tax relief provided by the HEART Act is estimated to exceed \$1.2 billion. The revenue loss associated with this legislation was offset in part by a new mark-to-market “exit tax” on certain individuals giving up their US citizenship or long-term foreign resident status.

Housing Assistance Tax Act of 2008

Enacted in July, the Housing Assistance Tax Act includes several provisions for housing-related tax relief, including special provisions for future and current homeowners. Among these, first-time home buyers with qualifying incomes who complete the purchase transaction between April 9, 2008 and June 30, 2009 will receive a tax credit of \$7,500 or 10 percent of the purchase price (whichever is the lesser amount). For 2008 only, current homeowners who take the standard, non-itemized federal income tax deduction are eligible for an additional deduction of up to \$1,000. The Housing Act also includes a low-income housing credit and a Real Estate Investment Trust (REIT) tax simplification package. Revenue offsets associated with this legislation include a new limit on the capital gains exclusion on sale of a principal residence. Beginning in 2009, taxpayers will be required to prorate their capital gain exclusion for periods the property was not used as a principal residence (“non-qualifying use”).

AMT credit

For individuals with older AMT credit carryovers, a new provision may help lower taxes over the next few years. Some taxpayers may be eligible for a refundable credit equal to a portion of these unused AMT credits. The credit may reduce an individual's tax liability, but it is only available for years in which the taxpayer is not in AMT. For the 2008 tax year, long-term unused minimum tax credits—related to AMT amounts paid in the 2004 tax year or earlier—would be reduced by amounts that have been recovered by AMT carryforward credits claimed. The credit is also reduced by the applicable percentage for phase-out of the personal exemption.

The AMT continues to be a political hot button, and Congress has yet to offer relief to individuals at the time this article went to press. Congress increased the AMT exemption to \$66,250 for joint filers and \$44,350 for single filers, and extended and increased certain other tax credits, such as education credits, against the AMT. If those temporary provisions are not extended again, more than 25 million taxpayers will be subject to the AMT in 2008.

The problem of the AMT is so complicated—and expensive—that most agree it can only be resolved as part of larger tax reform legislation. As a result, lawmakers are expected to enact another temporary one-year AMT patch by the end of this year, before the real debate over long-term solutions begins in 2009.

Individuals should review their AMT position before embarking on year-end planning actions. It may be more prudent to defer certain deductions (such as state and local taxes, investment expenses, etc.) to 2009 if paying these expenses before year end would result in AMT.

“Kiddie” tax provisions expanded

In 2008, the “kiddie” tax provisions will apply to children who are full-time students over the age of 18 but under the age of 24 and whose earned income does not exceed one-half the amount of their support.

Itemized deductions and personal exemptions for upper-income individuals

Prior year legislation relating to the phase-out of itemized deductions and upper-income individuals provides further benefit in 2008. For upper-income individuals, the phase-out of itemized deductions will fall to 1 percent from 2 percent. Additionally, the phase-out of personal exemptions will be reduced by two thirds from prior years resulting in a minimum \$2,333 for each personal exemption claimed, regardless of the individual's income level.

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