

**GRS RESEARCH MEMORANDUM***

RE: Medicare Part D Prescription Drug Benefits and Subsidies for Employer-Sponsored Retiree Drug Coverage
FROM: Mary Ann Vitale and Paul Zorn, Director of Governmental Research
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Overall, Medicare covers 42 million people, including 35.4 million seniors and 6.3 million disabled people under age 65. Participation in Medicare is expected to grow to 61 million by 2020 and 78 million by 2030. In 2005, Medicare benefit payments totaled \$325 billion (about \$7,800 per participant), accounting for 13 percent of the federal budget. Forty percent of Medicare participants report being in very good to excellent health, 50 percent report being in good to fair health, and 10 percent report being in poor health.¹ Most Medicare participants have modest incomes: 50 percent have incomes below 200 percent of poverty.²

Prior to the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (which becomes effective January 1, 2006), Medicare did not cover outpatient prescription drugs. In 2003, total outpatient prescription drug spending for Medicare beneficiaries (including out-of-pocket spending) amounted to \$95 billion and averaged about \$2,300 per beneficiary.³ Total annual outpatient drug spending was distributed among Medicare beneficiaries as follows:

- 61 percent spent less than \$2,000 (totaling 19 percent of total prescription drug spending for Medicare beneficiaries);
- 28 percent spent between \$2,000 and \$5,000 (totaling 39 percent of drug spending); and
- 11 percent spent over \$5,000 (totaling 42 percent of drug spending).⁴

Since Medicare did not provide outpatient drug coverage in 2003, prescription drug spending was paid through employer-provided retiree health insurance, other private coverage (e.g., Medigap), or paid out-of-pocket by the retirees. According to the 2000 Medicare Current Beneficiary Survey, prescription drug expenditures for Medicare beneficiaries age 65 and older were paid through the following sources:

- 42 percent was paid out-of-pocket;
- 36 percent was paid through private insurance;
- 13 percent was paid through Medicaid and other public sources; and
- 9 percent was paid from other sources.

* The authors of this memorandum are not attorneys and the statements made are not intended as legal advice or opinion.

¹ MedPAC analysis of the Medicare Current Beneficiary Survey, 2001.

² Ibid.

³ Kaiser Family Foundation, *Medicare and Prescription Drug Spending Chartpack*, June 2003.

⁴ Ibid.

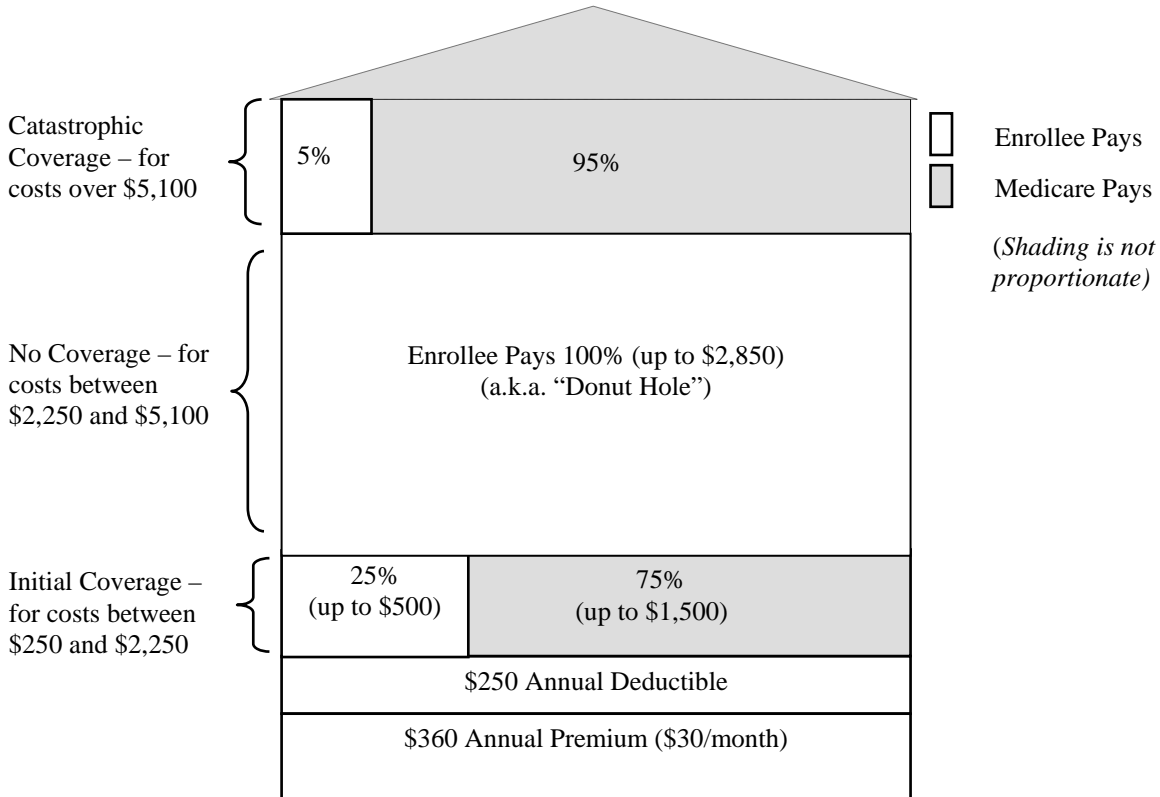
Medicare Part D Coverage

On December 8, 2003, President Bush signed into law the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (also referred to as the Medicare Modernization Act or MMA). Starting in 2006, the Act provides a new prescription drug benefit for Medicare enrollees under Medicare Part D. Additionally, the Act provides new federal subsidies for employers that continue to provide drug coverage to retirees, as long as the coverage is at least actuarially equivalent to coverage under Medicare Part D.

Beginning January 1, 2006, Medicare eligible/enrolled individuals may voluntarily enroll in Medicare Part D standard coverage, provided through private, risk-bearing, stand-alone plans referred to as Prescription Drug Plans (PDPs). For coverage in 2006, enrollees would pay a monthly premium of about \$30 and an annual deductible of \$250.⁵ In return, Medicare would pay:

- 75% of the enrollee’s outpatient prescription drug costs between \$250 and \$2,250;
- None of the enrollee’s outpatient prescription drug costs between \$2,250 and \$5,100 (also known as the “donut hole”); and
- 95% of the enrollee’s out-of-pocket prescription drug costs over \$5,100 (i.e., catastrophic coverage).

This is illustrated in the following graph:



⁵ Centers for Medicare & Medicaid Services, *Medicare Fact Sheet*, August 9, 2005. CMS originally estimated the Medicare Part D premium would be \$35 per month. On August 29, 2005, it announced that premiums charged by drug plan providers would likely range from \$20 to \$30 per month, as a result of competition among the Part D plan providers.

True Out-of-Pocket Costs

Under Medicare Part D, catastrophic coverage does not begin in a given year until the enrollee's "true out-of-pocket costs" exceed \$3,600. This is the sum of:

- the annual deductible (\$250);
- the enrollee's portion of the initial coverage (i.e., \$500 or 25% x [\$2,250 - \$250]), and
- the enrollee's portion of the donut hole (i.e., \$2,850 or 100% x [\$5,100 - \$2,250]).

Thus, Medicare begins paying 95 percent of prescription drug costs only after the enrollee's total prescription drug costs reach \$5,100 – of which \$3,600 has been paid by the enrollee and \$1,500 has been paid by Medicare Part D.

In order for the enrollee's \$3,600 to count toward catastrophic coverage, the payments must meet the definition of "true out-of-pocket" costs (TrOOP). Part D defines TrOOP costs as only those paid by the enrollee, another individual (e.g., a family member), a charity, or a State Pharmaceutical Assistance Program. Payments made by the employer or an insurance plan do not count as TrOOP costs and therefore, do not count toward catastrophic coverage. For example, if the employer paid the \$250 annual deductible, it would increase the dollar amount at which catastrophic coverage could begin for the enrollee to \$5,350 (\$5,100 + \$250). However, since payments for monthly premiums are not included in the definition of TrOOP costs, an employer can pay the enrollee's Part D premiums without increasing the dollar amount at which catastrophic coverage begins.

Employer Options for Retiree Drug Coverage

In responding to the new Part D program, employers have the following options for providing prescription drug coverage to Medicare-eligible retirees:

- 1) Provide an "actuarially equivalent" prescription drug plan and receive a tax-free federal subsidy;
- 2) Provide separate drug coverage that supplements or "wraps around" Medicare Part D;
- 3) Coordinate drug coverage through Medicare Prescription Drug Plans (PDPs);
- 4) Sponsor an employer PDP through a waiver process with the Center for Medicare and Medicaid Services (CMS);
- 5) Offer a Medicare Advantage Prescription Drug Plan (MA-PDP); or
- 6) Drop drug coverage and possibly offer to pay retirees' monthly Medicare Part D premiums.

The remainder of this memorandum discusses employer subsidies under Medicare Part D and employer supplemental ("wrap-around") coverage.

Employer Subsidies Under Part D

The MMA does not prevent employers or other health care plan sponsors from providing prescription drug coverage that is at least actuarially equivalent to Part D. In analyzing earlier versions of the legislation, the Congressional Budget Office (CBO) estimated approximately one-third of Medicare beneficiaries would lose employer-sponsored drug coverage as a result of Part D. Consequently, Congress added federal subsidies to encourage employers to continue providing prescription drug coverage for retirees.

To be eligible for the subsidy, an employer must provide an actuarial certification that its plan's prescription drug coverage is "actuarially equivalent" to the standard Part D benefit. In return, Medicare will pay 28 percent of the employer's incurred "allowable costs" for outpatient prescription drugs

between \$250 and \$5,000 per “qualified individual.” A “qualified individual” must be eligible for Part D coverage, but have elected to receive his or her drug benefit through the employer instead. The maximum subsidy is \$1,330 per member (i.e., 28% x [\$5,000 - \$250]), and is indexed for certain future cost increases. According to CMS, the subsidy is expected to average about \$668 per qualified individual.

The subsidy is not taxable income for the employer. Moreover, private-sector employers can take a tax deduction for the cost of providing the prescription drug plan. State and local governments that sponsor retiree health care plans are eligible for the subsidy, but do not benefit from the tax deduction, since they are already tax-exempt entities.

Allowable Costs

Allowable costs are actual incurred drug costs under a qualified plan by a qualified individual that is paid either by the plan sponsor (e.g., the employer) or plan member. These costs must be for drugs covered by Medicare Part D and include dispensing fees, but exclude administrative costs, discounts, rebates, etc. It is important to note that the employer can receive a subsidy for allowable costs paid by members. However, a plan where members pay most or all of the costs would not be “actuarially equivalent” to the Part D benefit.

Actuarial Equivalence

Determining actuarial equivalence involves a two-part test to ensure that both the gross and net value of the plan sponsor’s retiree prescription drug benefit is at least equal to the Part D standard benefit. The first part is the “gross value” test which measures whether the expected value of prescription drug benefits for Medicare-eligible individuals under the employer’s prescription drug program is at least equal to the expected value of the standard Part D benefit. The gross value test is used to determine whether the plan provides “creditable coverage” (that is, whether the drug coverage that is expected to be paid out will, on average, be at least equal to the standard Medicare prescription drug coverage). In order to meet certain disclosure requirements under Part D, employers that provide prescription drug coverage to Medicare-eligible individuals must perform this test whether or not they apply for the subsidy. (See the Creditable Coverage Notice section, later in this memorandum.)

The second part is the “net value” test which measures whether the expected value of plan benefits minus retiree contributions for prescription drug coverage is at least equal to the expected value of the standard Part D benefit minus the Part D premium adjusted for supplemental coverage.

Requirements for Receiving the Subsidy

The following five steps are required for employers to receive the prescription drug subsidy:

- 1) **Submission of an annual application for the employer subsidy.** For the retiree drug subsidy beginning January 1, 2006, an application must be submitted to CMS by October 31, 2005.⁶ In subsequent years, calendar year plans must submit applications by September 30 and non-calendar year plans must submit applications 90 days prior to the beginning of each plan year.
- 2) **Provide attestation of actuarial equivalence.** CMS requires certification by a member of the American Academy of Actuaries that the plan meets the actuarial equivalence standards. For each plan, an actuary’s attestation must be provided with the application by the applicable deadlines.

⁶ The deadline for applying for the Part D subsidy was originally September 30, 2005. However, on September 2, 2005, CMS announced the deadline’s extension to October 31, 2005.

- 3) **Certify disclosure of creditable coverage status.** Employers must disclose to plan participants and CMS whether or not each plan provides creditable coverage. CMS has issued creditable coverage guidance with sample disclosure language that can be incorporated into other plan communications. (See the Additional Resources section at the end of this memo for links to CMS guidance on creditable coverage.)
- 4) **Electronically submit and periodically update enrollment information.** Employers must provide enrollment information about retirees and dependents to CMS to be updated periodically.
- 5) **Electronically submit incurred drug cost data.** Employers must provide aggregate data on incurred drug costs and reconcile cost data at year-end to CMS.

Creditable Coverage Notice

The MMA requires every plan sponsor that offers prescription drug coverage to provide a notice to CMS of the plan's creditable coverage status annually and upon any change in creditable coverage status. This notice is due by September 30, regardless of whether the plan offers "creditable" or "noncreditable" coverage.⁷

In addition, plan sponsors must notify Part D eligible participants of the plan's creditable coverage status at the following times:

- Annually prior to November 15;
- Before the initial enrollment period for Part D;
- Before the effective date of enrollment in the employer's drug plan;
- When drug coverage ends or the status of creditable coverage changes; and
- Upon the beneficiary's request.

A simplified creditable coverage test may be used if an employer is not applying for the Part D subsidy. Under the simplified test, the prescription drug plan must satisfy several requirements such as providing at least 60 percent of participants' prescription drug expenses, on average.

Advantages and Disadvantages of the Employer Subsidy

The main advantage of the Part D subsidy for employers is the tax-free reimbursement for 28 percent of allowable costs incurred for outpatient prescription drug benefits. This has been estimated to save approximately 20 percent of the employer's allowable drug spending annually. Another advantage is that, by continuing the current plan, there will be less disruption in benefits provided to members and therefore less of a need to communicate benefit changes. The disadvantages include the required annual certification of the plan for actuarial equivalence, as well as additional plan administration and reporting requirements related to applying for the subsidy, and processing subsidy payments.

Employer Supplemental ("Wrap-Around") Coverage

Instead of offering prescription drug coverage, employers could require Medicare eligible plan members to select the Part D benefit, but also offer coverage that supplements Part D. For example, the employer could offer to pay the Part D premiums for enrollees, as well as a portion of out-of-pocket expenses. The employer would not receive the 28 percent subsidy, but Medicare would become the primary payer and the employer could structure this to lower long-term costs. Additionally, cost trends attributable to

⁷ As noted in an earlier footnote, CMS extended the application deadline for the Part D subsidy from September 30, 2005, to October 31, 2005. At this writing, it is unclear whether that extension also applies to the deadline for submitting creditable coverage notices to CMS.

prescription drug costs could be excluded from the OPEB valuation thereby lowering the reported liability.

A disadvantage of this approach is that employer payments for out-of-pocket costs do not advance the member toward Medicare's catastrophic prescription drug coverage. As discussed earlier, to be eligible for Medicare's 95 percent catastrophic prescription drug coverage, the \$3,600 must first be paid out-of-pocket.

Medicare Part D Implementation

CMS continues to issue guidance for plan sponsors and several key dates are approaching that require decisions and actions by employers. The most significant upcoming deadlines include:

- **October 31, 2005** – Employers must submit applications for the federal subsidy for calendar year 2006, including required actuarial attestations, to CMS by October 31, 2005.
- **November 15, 2005** – Employers that provide prescription drug plans must notify active and retired employees (and their spouses and dependents) about the plan's creditable coverage. Moreover, employers also need to inform plan participants that are entitled to Medicare benefits whether or not the plan provides creditable coverage. This notice requirement is applicable whether or not the employer applies for the federal subsidy.

Medicare Part D Implementation Timeline for 2006 Coverage

Requirement	Due Date
CMS begins communications to retirees about Part D	October 1, 2005
Application for subsidy (for all plan sponsors whether operating on a plan or calendar year)	October 31, 2005
Open Enrollment begins (creditable coverage certification required)	November 15, 2005
Retiree drug subsidy program begins	January 1, 2006

It is likely that most state and local government-sponsored retiree prescription drug plans are actuarially equivalent to the Part D benefit. Therefore, they would be eligible for the 28 percent subsidy after obtaining certification that their prescription drug benefit is actuarially equivalent. If the government is unable to certify actuarial equivalence this year, the option is still open for future years.

Additional Resources

Guidance on the Part D subsidy is available on the CMS website at:
<http://rds.cms.hhs.gov>

Guidance on creditable coverage and model language for creditable coverage disclosure notice is at:
<http://www.cms.hhs.gov/medicarereform/credcovrg.asp>

Basic questions and answers about Medicare Prescription Drug Coverage are at:
<http://www.cms.hhs.gov/partnerships/news/mma/qsandas.pdf>