



Frequently Asked Questions: Retiree Drug Subsidy

Under § 139A of the Internal Revenue Code, special subsidy payments made under §1860D-22 of the Social Security Act (a retiree drug subsidy, or RDS, payment) are not included in the gross income of plan sponsors. Plan sponsors receive RDS payments based on the allowable retiree costs (as defined under § 1860-22(3)(C)(i) of the Social Security Act) for certain qualified retiree prescription drug plans.

Generally, taxpayers may not deduct costs that are reimbursed, for which they have a right of reimbursement, or that relate to income on which the taxpayers were not taxed (excluded income). However, for taxable years beginning on or before December 31, 2012, § 139A provides an exception that allows plan sponsors to disregard the excluded income for purposes of determining the deductibility of their costs for the plan year for which they received the subsidy. This exception generally results in a greater deductible amount than if the exception did not apply.

For taxable years beginning after December 31, 2012, § 139A has been amended to remove the language that allows plan sponsors to disregard the excluded income for purposes of determining whether a deduction is allowable for subsidized costs. Accordingly, plan sponsors may continue to exclude the RDS payments from gross income, but will be subject to the normal rules disallowing a deduction for expenses for which the sponsors are reimbursed, have a right of reimbursement, or relate to excluded income.

The following questions and answers provide information on the federal tax consequences to a plan sponsor that pays or incurs retiree prescription drug costs in a plan year, receives or has a right to receive an RDS payment related to those costs, and undergoes reconciliation in a later year. We use the term “costs” to mean costs within the meaning of § 1860D-22(3)(C)(i) of the Social Security Act that would qualify as deductible in the current year (without regard to whether the amounts are subject to reimbursement). For purposes of these FAQs, we assume that the plan sponsor uses an accrual method of accounting and the plan is not a VEBA or other welfare benefit plan.

Question 1. A plan sponsor’s taxable year and plan year each begin on January 1 and end on December 31. The sponsor incurs and deducts costs for 2012 and receives RDS payments for part of these costs in 2013. How do the RDS payments affect the amount of the deduction for the costs incurred in 2012?

Answer 1. The plan sponsor incurs the costs in taxable year 2012, before the amendment to § 139A is effective. The deductibility of these costs is governed by the law in effect in 2012. The sponsor may disregard the RDS payments in determining the amount allowable as a deduction for costs incurred in 2012.

Question 2. The facts are the same as in Question 1, except that the plan sponsor incurs and deducts the costs for 2013 and receives RDS payments for part of these costs in 2014. How do the RDS payments affect the amount allowable as a deduction for the costs incurred in 2013?

Answer 2. The plan sponsor incurs the costs in taxable year 2013, after the amendment to § 139A is effective. The deductibility of these costs is governed by the law in effect in 2013. The sponsor may not disregard the RDS payments it has a right to receive in determining the amount allowable as a deduction for costs incurred in 2013. The sponsor must, therefore, reduce the amount of its deduction for the costs in 2013 by the amount of the RDS payments it has a right to receive.

Question 3. A plan sponsor's taxable year begins on October 1 and ends on September 30. The sponsor's plan year begins on January 1 and ends on December 31. The sponsor incurs and deducts costs for 2012 and 2013. The sponsor receives RDS payments for the 2012 plan year in 2013 and for the 2013 plan year in 2014. How do the RDS payments affect the amount allowable as a deduction for the costs incurred in 2012 and 2013?

Answer 3a. The 2012 Plan Year. Costs the plan sponsor incurs for the 2012 plan year (January 1 to December 31, 2012) are incurred in part in the taxable year beginning October 1, 2011, and in part in the taxable year beginning October 1, 2012. The amendment to § 139A applies to taxable years beginning after December 31, 2012. The sponsor's costs for the 2012 plan year are incurred in two taxable years, both beginning before January 1, 2013. Therefore, the sponsor's deductions are governed by the law in effect in 2012. The sponsor may disregard the RDS payments it receives in 2013 in determining the amount allowable as a deduction for costs incurred during the 2012 plan year.

Answer 3b. The 2013 Plan Year. Costs the plan sponsor incurs for the 2013 plan year (January 1 to December 31, 2013) are incurred in part in the taxable year beginning October 1, 2012, and in part in the taxable year beginning October 1, 2013. Costs the sponsor incurs for the period January 1, 2013, to September 30, 2013, are incurred in the taxable year beginning October 1, 2012. The deductibility of these costs is governed by the law in effect in 2012, and the sponsor may disregard the RDS payments it receives in 2014 in determining the amount allowable as a deduction for costs incurred in the period January 1, 2013 to September 30, 2013.

Costs the sponsor incurs for the period October 1, 2013, to December 31, 2013, are incurred in the taxable year beginning October 1, 2013. The deductibility of these costs is governed by the law in effect in 2013. The sponsor must reduce the amount of its deduction for costs incurred during this period by the amount of the RDS payments it has a right to receive for costs incurred in the period October 1, 2013, to December 31, 2013.

Question 4. A plan sponsor's taxable year and plan year each begin on January 1, 2012, and end on December 31, 2012. The sponsor incurs and deducts costs for 2012. In 2014, the sponsor undergoes reconciliation for RDS payments received for costs incurred in the 2012 plan year. Reconciliation shows that additional amounts of the sponsor's costs were qualified costs and the sponsor receives additional RDS payments. How do the additional RDS payments affect the amount allowable as a deduction for costs incurred in 2012?

Answer 4. The additional RDS payments the plan sponsor receives through reconciliation in 2014 relate to costs the sponsor incurs in 2012. The deductibility of these costs is governed by the law in effect in 2012. Therefore, the sponsor may disregard the additional RDS payments it receives as a result of reconciliation in 2014 in determining the amount allowable as a deduction for costs incurred in 2012.

Question 5. A plan sponsor's taxable year and plan year each begin on January 1, 2013, and end on December 31, 2013. The sponsor incurs and deducts costs for 2013. The sponsor calculates its costs with reasonable accuracy when preparing its taxable year 2013 income tax return. In 2015 the sponsor undergoes reconciliation for RDS payments for costs incurred in the 2013 plan year. Reconciliation shows that additional amounts of the sponsor's costs were qualified costs and the sponsor receives additional RDS payments. How do the additional RDS payments affect the amount allowable as a deduction for costs incurred in 2013?

Answer 5. The additional RDS payments the plan sponsor receives through reconciliation in 2015 relate to costs the sponsor incurs in 2013. The deductibility of these costs is governed by the law in effect in 2013. As a result of the additional RDS payments after reconciliation, the sponsor may have deducted an excessive amount on its 2013 income tax return. Because the sponsor calculated its costs with reasonable accuracy on its 2013 income tax return, the sponsor reports the amount of the additional RDS payments as income on its 2015 income tax return to the extent required under the tax benefit rule.

Question 6. The facts are the same as in Question 5, except that reconciliation determines that the plan sponsor received excess RDS payments and the sponsor repays the excess. How does returning the excess RDS payments affect the amount allowable as a deduction for costs incurred in 2013?

Answer 6. As a result of the plan sponsor's repayment of RDS payments after reconciliation, the sponsor may have deducted a lower amount of costs on its 2013 income tax return than was allowable. Because the plan sponsor calculated the amount of its deduction for the 2013 costs with reasonable accuracy, the sponsor deducts the additional amount it may have deducted for 2013 on its 2015 income tax return.