Health-care reform and its impact on investors

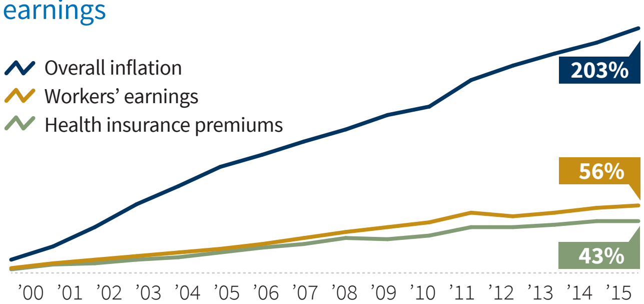
The road to reform

The U.S. health-care system has faced challenges for decades resulting from rising costs, federal budget pressures, and an aging population. In an effort to manage costs and expand health insurance coverage to millions of uninsured individuals, the Affordable Care Act (ACA) was signed into law in 2010 and has been implemented over several years.

Health-care costs are rising rapidly

Data clearly show that U.S. citizens have long paid more per capita for health care than any other country in the world — more than twice the average of peer nations [OECD Health Data, 2015]. Why this is true is an issue of some debate, however. Many believe the United States offers the best medical services in the world, and the costs reflect that quality; others point to the fact that the United States has one of the highest rates of income per capita, suggesting money is being freely spent on health care by choice. Still others point to high levels of regulation and inefficient markets to explain the rapid increase in prices. The causes of health-care cost inflation are myriad and uncertain, but one thing is indisputable: Costs have risen dramatically, with few forces working to push them down.

Health-care costs are outpacing inflation and earnings

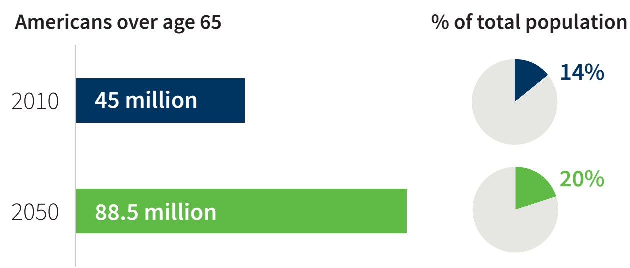


Source: Kaiser Family Foundation, September 2015.

An aging population will further strain the system

The majority of health-care spending occurs late in life, often in fighting the diseases that are the leading causes of death. As the baby boom generation ages and begins to confront late-life medical conditions, demand will almost certainly increase for costly and intensive medical treatment. Meanwhile, there is scant evidence to suggest a corresponding increase in the supply of medical staff and services; as a result, the cost of care is likely to rise.

The number of Americans age 65 or older will nearly double in the next 40 years



Source: U.S. Census Bureau, 2014 projections.

Government spending on health-care programs rapidly increasing

Entitlement spending in the United States, especially for health-care-related programs, is already stretched to the breaking point. Annual government spending for Medicare and Medicaid exceeded $930 billion in 2015 [CBO, August 2015]. One of the key factors driving this increase is that the number of workers paying into the Medicare system via payroll taxes is decreasing relative to the number of retirees receiving benefits. For example, currently there are 3.2 workers per Medicare beneficiary. This number is predicted to decline to 2.3 workers per beneficiary by 2030 [2015 Medicare Trustees Report].

Key elements of the Affordable Care Act

Coverage for the insured and the uninsured was expanded

Dependents covered to age 26	Expanded insurance coverage for a dependent up to age 26 even if he or she is no longer living with a parent, is not a dependent on a parent's tax return, or is no longer a student.
Medicaid expanded to subsidize lowest-income households	For states that opt to extend their Medicaid program, fully subsidized coverage is provided to those earning less than a minimum of 138% of the Federal Poverty Limit (FPL).* State-administered Medicaid programs are expanded to include ALL low-income groups, not just certain groups such as children or pregnant women. For example, in most states, childless adults were not eligible for Medicaid prior to the ACA.
Premium tax credits available to low- and moderate-income households	For those above the threshold for receiving fully subsidized coverage through Medicaid, tax credits are available to purchase policies via health-care exchanges. Taxpayers with income between 138% and 400% of the FPL may receive a tax credit to help offset the cost of obtaining coverage. Individuals with income below $47,520 and families of four with income below $97,200 may claim a credit.
Insurance policies must offer a base level of coverage	Health-care coverage must cover a minimum of 60% of out-of-pocket costs and include "essential health benefits" (e.g., ambulatory services, emergency, maternity, hospitalization, mental health, prescription drug, rehabilitative, laboratory, preventive/wellness, and pediatric including oral and vision).
Tax credit available to small businesses	Businesses with 25 or fewer employees with average annual wages of less than $50,000 are eligible for a tax credit to offset the cost of providing health-care insurance coverage to employees. For 2014 and following years, the maximum tax credit equals 50% of costs.

* For 2016, the FPL is $11,880 for an individual and $24,300 for a family of four.

Individuals and employers face insurance mandate

Individual mandate	Requires those without coverage to obtain health insurance or pay a tax penalty that increases over time. In 2016, the penalty is the greater of 2.5% of income or $695 ($2,085). Certain lower-income families and groups are excluded from the mandate.
Employer mandate	Imposes a penalty of $2,000 per full-time employee on larger businesses (50 or more employees). For purposes of calculating the penalty, the first 30 employees are excluded. There is also a mandate to provide affordable coverage, defined as covering at least 60% of out-of-pocket costs and not requiring employees to pay more than 9.5% of their income on coverage. In this case, employers face a $3,000 penalty for each employee who forgoes employer-based coverage and instead obtains subsidized coverage via a health-care exchange.

Health-care exchanges

The ACA established online marketplaces where consumers (or certain small businesses) can shop for and purchase health-care coverage. To receive individual tax credit subsidies or small business tax credits, coverage must be purchased via an exchange. The federal government has created different tiers of coverage options based on out-of-pocket costs, deductibles, etc.

Plan	Actuarial value	Typical deductible	Typical coinsurance
Bronze	60%	$5,000	30%
Silver	70%	$2,000	20%
Gold	80%	$0	20%
Platinum	90%	$0	10%

Taxes and tax increases were introduced to offset costs

Provision	Description
A 3.8% surtax on net investment income	Applies to higher-income households (individuals with more than $200K in modified adjusted gross income [MAGI] or couples with more than $250K in MAGI).* Additional tax of 3.8% on net investment income such as interest, dividends, rental income, certain annuity income, and passive business income. Income from retirement plan distributions (pensions, 401(k), IRAs, etc.) is excluded as is municipal bond interest.
A 0.9% Medicare payroll tax	For higher-income taxpayers (individuals with more than $200K in earned income or couples with more than $250K in earned income), the individual portion of the payroll tax increases from 1.45% to 2.35%.
Limitation on deducting medical expenses	Increases the threshold for deducting medical expenses on the federal income tax return from 7.5% of adjusted gross income (AGI) to 10% of AGI.
Limitations on health-care savings accounts	FSA contributions capped at $2,500 (previously, employers would establish a maximum contribution amount). Ban on using funds from flexible spending accounts, health reimbursement arrangements, or health savings accounts for the cost of over-the-counter medications.
Excise tax on medical devices	Sale of medical devices is subject to an excise tax of 2.3%. Items sold at retail to consumers are excluded.†

* MAGI is defined as adjusted gross income plus net foreign income exclusion amount.
† Legislation signed into law in 2015 suspends this tax for 2016 and 2017.

Fundamental changes were made to how health insurance works

Guaranteed issue	Insurance companies cannot deny coverage based on pre-existing medical conditions. Previously, insurance companies (in most states) could deny or exclude non-group coverage based on certain health factors or prior medical expenses. The average denial rate prior to the law was 18%.*
Limits on medical underwriting to determine premiums	Prior to the law, insurers could base premiums on extremely detailed health and medical history information provided by applicants. Under the ACA, insurers are limited to just a few factors when determining cost such as age (and then only limited to three times younger adults), geographic area, and tobacco use.
No dollar limits on coverage	Insurers can no longer impose an annual or lifetime dollar limit on benefits provided. Previously, the insured was responsible for paying costs in excess of those limits.
Limits on waiting periods	The law prohibits employer health plans from applying a waiting limit exceeding 90 days for eligible employees' health-care coverage to begin.
Requirements on insurers	Medical loss ratio standards require insurers to spend 80%–85% of premium dollars on health care (instead of administration costs, marketing, profits, etc). Additionally, premium increases of 10% or more must be justified through a rate review process. Insurers who do not comply may be excluded from participating in health-care exchanges.

* Kaiser Family Foundation, September 2013.

Three ways to mitigate the impact of higher taxes due to health-care legislation

With an increase in marginal tax rates, the return of income phaseouts on deductions and exemptions, and taxes associated with health-care reform, tax-smart planning for higher-income taxpayers is more critical.

1. Invest in municipal bonds to generate tax-free income

The tax-free income paid by municipal bonds is one way to offset the potential for higher tax rates. Municipal bond income also is exempt from the Medicare surtax. Additionally, income from municipal bonds is not considered when calculating the income threshold for applying the 3.8% surtax. And because municipal bonds are often backed by the taxing power of local governments, defaults have been extremely rare, making them a relatively stable investment. Consider investing in municipal bonds with taxable assets that you do not intend to tap into over the near term.

2. Converting or contributing to a Roth IRA can create a source of tax-free retirement income

Distributions from retirement accounts, including Traditional and Roth IRAs, are exempt from the 3.8% Medicare surtax. Roth IRAs provide additional benefits since withdrawals are generally free from income taxes as well.

Although IRA withdrawals are not subject to the Medicare surtax, IRA income may push a taxpayer past the threshold, exposing other investment income to the new surtax. This is where a Roth IRA may help.

3. Consider strategies to reduce or avoid taxable income

Some taxpayers will have to plan for higher taxes because of higher marginal tax rates, a reduction in tax preference items like itemized deductions, or due to the 3.8% Medicare investment income surtax. Taxpayers can utilize certain strategies to manage their income level to avoid exceeding thresholds that may result in a bigger tax bill including:

- Contributing to an IRA, 401(k), or other retirement account
- Funding a Flexible Spending Account (FSA) for health-care, dependent-care, and transportation expenses
- Contributing to a Health Savings Account (HSA)
- Deferring compensation
- Being mindful of transactions, such as the sale of a highly appreciated asset, which may increase overall income above thresholds for the 3.8% surtax.
- Avoiding taxes on IRA distributions by directing funds to a qualified charity instead (must be 70½ years of age).
- Shifting income to other family members if possible

Talk to your financial advisor or tax professional today

As lawmakers in Washington address challenges such as the expanding budget deficit and rising health-care costs, investors would be well served to keep a close eye on how this will impact their personal finances. The best preparation you can make is to consult with a financial advisor or tax professional, who can offer some perspective on your specific financial and tax situation, help you understand the risks, and position your assets accordingly.

Consider these risks before investing: Funds that invest in bonds are subject to certain risks including interest-rate risk, credit risk, and inflation risk. As interest rates rise, the prices of bonds fall. Long-term bonds are more exposed to interest-rate risk than short-term bonds. Unlike bonds, funds that invest in bonds have ongoing fees and expenses. The funds invest in fewer issuers or concentrate their investments by region or sector, and involve more risk than a fund that invests more broadly.

This information is not meant as tax or legal advice. Please consult with the appropriate tax or legal professional regarding your particular circumstances before making any investment decisions.

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