Understanding the Impact of Modified Adjusted Gross Income on Retirement Health Care Costs

STRATEGIES TO REDUCE MEDICARE INCOME SURCHARGES

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SUMMARY

In terms of retirement planning, many Baby Boomers have done everything right. They have calculated future expenses, invested in IRAs and 401(k)s, and labored for decades to maximize their pensions and Social Security—all to generate the necessary income to enjoy a lengthy and financially secure retirement. They believe—and with good reason— they are ready to enjoy their golden years.

Unfortunately, it still might not be enough.

Many retirees will be surprised when they see their Social Security checks diminished by Medicare premiums and surcharges, which will not only reduce monthly income, but may also strain household budgets.

Medicare levies surcharges by measuring Modified Adjusted Gross Income (MAGI). These extra payments begin at $85,000 for an individual or $170,000 for a married couple. Initially, these figures may seem high, but since the baseline values are not expected to change over time, more and more retirees (whose incomes will rise with inflation) will cross these thresholds and be subject to the surcharges.

Crossing the first threshold can increase Medicare Parts B and D costs by approximately 35%, and surpassing the highest thresholds can inflate costs by more than 200%. The combination of surcharges and health care cost inflation may place a considerable financial burden on retirees, validating their concerns about being able to afford quality health care in retirement.

This white paper discusses the relationship between MAGI and Medicare surcharges, analyzes their impact on retirement health care costs, and outlines strategies to help current and future retirees plan for, manage, and potentially reduce these costs.

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HEALTH CARE COSTS IN RETIREMENT

The U.S. Office of the Actuary projects that health care costs will continue to grow by around 6% annually for the next eight years,[1] outpacing anticipated Social Security cost of living adjustments (COLAs). The most recent COLA for Social Security was less than 2%--a difference of four percentage points. As the gap between the rising cost of health care and Social Security benefits widens over time, the amount individuals will have to allocate to health care will also grow.

Retirement health care costs may far exceed what most Americans imagine or expect. Since Medicare only covers approximately 50% of health care expenses[2], which are projected to continue to increase, Americans will have to allocate a greater portion of their savings to cover these costs. Ironically, increasing retirement income, which may seem like the ideal solution, can actually work against retirees. Those whose annual income propels them across MAGI thresholds will have to pay significantly more for the same services.

While the cost of retirement health care will be significant, advisors and their clients can take steps to manage the expense. Understanding how income and Medicare surcharges are interrelated, allocating funds specifically for health care, and employing a knowledgeable financial advisor to choose the right products to reduce MAGI may save retirees tens of thousands of dollars in retirement.

MEANS TESTING AND THE MEDICARE MODERNIZATION ACT

Medicare currently provides health coverage to 50.7 million subscribers.[3] As more and more boomers turn 65, Medicare enrollment will reach 64 million in 2020 and 81 million in 2030.[4] Couple this with a projection of only 2.5 workers to every retiree by 2030, and this federal entitlement program has the potential to dwarf all others. To help pay for the program, The Medicare Modernization Act was passed to charge more to those who could "afford" it. Means testing for Parts B and D was officially introduced in 2007. This basically translates into "The more you make, the more you pay."

TABLE 1[5]

Medicare Surcharge Brackets' Impact on Monthly Premiums

Individual Income (MAGI)	Married Income (MAGI)	Medicare Part B	Medicare Part D*	Total**
Under $85,000	Under $170,000	$104.90	$44.00	**$148.90**
$85,001-$107,000	$170,001-$214,000	$104.90 **+$42.00**	$44.00 **+$12.10**	**$203.00**
$107,001-$160,000	$214,001-$320,000	$104.90 **+$104.90**	$44.00 **+31.10**	**$284.90**
$160,001-$214,000	$320,001-$428,000	$104.90 **+167.80**	$44.00 **+50.20**	**$366.90**
Above $214,000	Above $428,000	$104.90 **+$230.80**	$44.00 **+69.30**	**$449.00**

* Based on Part D National Average
** Based on 2014 monthly premiums for an individual

The income thresholds in Table 1 are not indexed to inflation and have been in place for seven years. If Medicare is to remain viable as millions more enter the system, it is unlikely that Congress will consider raising them any time soon. As a result, as household incomes rise with inflation, it is only a matter of time before more future Medicare subscribers—and not necessarily just affluent ones—find themselves in higher thresholds.

For example, assuming a 3% inflation rate, a 40-year-old currently earning $40,000 annually will be in the second income bracket at retirement, and face around a 35% surcharge. In simple terms: over time, a large number of Americans will be impacted by Medicare surcharges. Current HealthView Services data already shows 35% of advisor-clients are expected to incur Medicare surcharges. This number is expected to significantly increase over time.

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CHANGING FROM ACCUMULATION TO DECUMULATION

With the move away from traditional pensions to defined contribution plans, the financial services industry has maintained a steady focus on saving for retirement, but paid little attention to how Medicare measures income earned from certain investment products. To be fair, means testing has only been relevant for the past few years, but since specific types of income trigger Medicare surcharges, it is essential to identify what income counts toward MAGI, and what does not.

By modifying the mix of products in a portfolio, an advisor may be able to migrate a client into a lower MAGI bracket, decrease the surcharges, and increase net disposable retirement income.

With this as the objective, let's examine some strategies that can help retirees avoid those surcharges.

LOWERING MAGI QUALIFIED INCOME

In order to fully comprehend, manage, and even reduce the impact of surcharges, it is necessary to understand that MAGI incorporates almost every potential source of income—including working in retirement, Social Security, pensions, required minimum distributions, earned interest, and capital gains. There is also a two-year look-back period. This rule can become especially troublesome at age 70½, when required minimum distributions (RMDs) must be taken, or when a spouse passes away, which may leave an income stream that could place the lone survivor into a higher income bracket.

Here's an example: Mary is a 55-year-old New York City public school teacher planning to retire at 66 with an annual pension of $80,000. She also has a 403(b), an IRA and other investments, which are projected to generate an additional MAGI income stream of $10,000 annually.

Mary will be placed in the second income bracket, (see Table 1) and that will cost her more than $71,000 in Medicare surcharges through her retirement. However, if Mary can reduce her MAGI by $5,000 annually, she will move into the first income bracket and avoid the surcharges.

To summarize: a middle-class individual with a pension and a few investments is affluent enough, according to Medicare, to end up in the second or third income bracket and face substantial surcharges—an expense that most have probably failed to factor into their retirement budgets.

Products including life insurance, non-qualified annuities, Roth IRAs and Roth 401(k)s, Health Savings Accounts (HSAs), longevity insurance, and even a reverse mortgage, can decrease MAGI and reduce Medicare Part B and D surcharges

REDUCING MAGI: A SHORT CASE STUDY

Tom's case examines how adjusting the combination of various investments products can lower his MAGI and save him a substantial amount of money over time.

Name	Tom
Age/Gender	55/Male
State of residence	Massachusetts
Current annual income	$110,000
Inflation	3%
Expected income in last year of employment	$152,265
Required income in retirement*	$114,000

**Based on 75% of income in last year of employment*

Based on the information above, Tom will be placed in Medicare's third income bracket. Here is what he can expect to pay for Medicare Parts B, and D.

TABLE 2

Income Level	Life expectancy	Lifetime Part B and D Premiums and Surcharges PRESENT VALUE	FUTURE VALUE
$107,001-$160,000	86	$70,570	$282,675

Tom meets with his advisor who runs the numbers and concludes the following: Tom can migrate down into the first Medicare income bracket merely by converting his future 401(k) contributions to a Roth 401(k), and by investing a portion of his taxable savings in a non-qualified annuity or variable universal life insurance policy. These portfolio modifications can reduce Tom's B and D premiums by $70,570 in today's dollars, or $138,087 in future dollars.

TABLE 3

Income Level	Life expectancy	Lifetime Part B and D Premiums		% Difference	Savings	
		PRESENT VALUE	FUTURE VALUE		PRESENT VALUE	FUTURE VALUE
Under $85,000	86	$73,382	$144,588	-	**$70,570**	**$138, 087**
$85,001-$107,000	86	$144,412	$282,675	**96% more**	-	

To put this in some perspective, if Tom invested $400,000 at a 6% return compounded annually, it would take him *over five years* to accumulate gains equivalent to what he can save by adjusting his investment mix.

Here's another perspective: moving into the first income bracket will increase Tom's disposable income by an average of $4,163 annually over his first ten years of retirement because his average annual Medicare Parts B and D expenses will fall from around $8,500 to a far more reasonable $4,300.

CONCLUSION

It is tempting to view current Medicare premiums and surcharges as manageable, and income brackets too high for most to worry about, but that would be a mistake. This notion may be true for some current retirees, but over time, inflation will propel more Boomers and younger cohorts across surcharge thresholds. Combine this with rising health care cost inflation, and aging Americans will experience much higher out-of-pocket costs and premiums throughout retirement.

The optimistic notion that the government will raise thresholds, or that health care inflation rates will decline significantly, is not realistic. After a modest decline through the economic downturn, health care inflation is returning to normalized levels. With tens of millions of retiring Boomers set to enter the already stressed Medicare system, surcharge brackets are unlikely to change any time soon.

Because this is a relatively new policy that has yet to receive the attention it deserves, neither the general public nor the financial services industry (with a few exceptions) has factored health care expenses or additional surcharges into retirement planning. As a result, more and more retirees on fixed incomes will find themselves drawing upon funds allocated for other purposes to pay for these costs.

Recognizing the critical role of MAGI, HealthView has created a comprehensive planning tool that integrates these variables into individualized Medicare expense projections. Advisors can then use the output to develop portfolios that can optimize income without raising MAGI.

In summary, allocating savings for retirement health care and modifying a portfolio's investment mix to lower Medicare-assessed income can help prepare people for future costs, reduce surcharges and increase disposable income in retirement.

ABOUT HEALTHVIEW SERVICES

HealthView Services (http://www.hvsfinancial.com) is the leading provider of retirement health-care-cost data and Medicare, Social Security, and long-term care planning tools for broker-dealers, insurers, financial advisors and individuals. HealthView Services believes that understanding expected future health care costs, one of the largest burdens facing retirees, should be a foundational component of retirement planning. The company's methodology initiates advisor/client conversations that ultimately lead to portfolio optimization in both the accumulation and decumulation phases of retirement.

HealthView Services' HealthWealthLink is an integrated retirement planning tool that draws upon cost data from more than 50 million annual health care cases to assist financial advisors in preparing personalized health care costprojections. Through the company's partnership with the Insured Retirement Institute (IRI), HealthView Prime, a health care retirement cost planning tool, is being offered to IRI's membership of major insurers, asset managers, broker dealers/distributors, and 150,000 financial professionals. Individuals can use a one-click version of HealthWealthLink to calculate average retirement health care costs: (http://apps.hvsfinancial.com/hvadvisor)

END NOTES

1 Press, Ricardo Alonso-zaldivar Associated. "Gov't Forecasts Rising Health Care Inflation." ABC News. ABC News Network, n.d. Web. 14 Sept. 2014.

2 "How Much Is Enough? Out-of-Pocket Spending Among Medicare Beneficiaries: A Chartbook." How Much Is Enough? Out-of-Pocket Spending Among Medicare Beneficiaries: A Chartbook. N.p., n.d. Web. 14 Sept. 2014.

3 See table II.B1 in Boards of Trustees, Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds, 2013 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds (Washington, DC: Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds, 2013), 10, http://downloads.cms.gov/files/TR2013.pdf. (http://apps.hvsfinancial.com/hvadvisor).

4 See table V.B4 in Boards of Trustees, 2013 Annual Report, 198.

5 Administration, Social Security. Medicare Premiums: Rules For Higher-Income Beneficiaries (2014): n. pag. Web.

6 "Workers Increasingly Shoulder Cost of Employer-sponsored Health Insurance : Special." Stltoday.com. N.p., 14 Sept. 2014. Web. 14 Sept. 2014.

Tables 2 and 3 courtesy of HealthView Services

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