



OUTCOMES ORIENTED PLAN DESIGNS



A 'Means' to an End

Retirement plans as a health care cost solution.



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According to a number of industry studies, health care costs are among the leading financial concerns of pre-retirees. Their unease is valid, as current data suggests that medical expenses will be one of the most significant costs in retirement. Aside from the projected growth of health care inflation to 6% and the fact that Medicare only covers approximately 50% of retirement medical costs, another variable will place significant stress on retiree budgets: Medicare means testing.

MAGI and Means Testing

To understand Means Testing, one needs to have a cursory understanding of Modified Adjusted Growth Income (MAGI). We are taught early on in our financial services careers to tactfully refer clients to accountants when complicated tax questions arise, but MAGI isn't as difficult a concept to master as it sounds. The number includes almost every source of income — including Social Security, required minimum distributions (RMDs), capital gains, and even tax-exempt interest from municipal bonds — earned in a household. It is used as a means-testing gauge to ascertain a household's ability to pay Medicare premiums. However, one income source that does *not* increase MAGI is revenue generated from a Roth 401(k).

In 2003, The Medicare Modernization Act sought to transfer some of the unwieldy costs of government spending back to more affluent subscribers by tacking on additional surcharges for Medicare parts B (doctor

visits and tests) and D (prescription drugs) based on MAGI. This approach sought to leverage rising Medicare costs by charging more to those who could “afford” it. In fact, Medicare premiums can vary by more than 200% from person to person (for the same coverage) depending on their income bracket.

Unfortunately, these brackets are not currently indexed to inflation, which is why means testing will soon become a mainstream issue. HealthView has found that as household incomes rise — even with just basic cost of living adjustments (COLAs) — it is only a matter of time before more future Medicare recipients (and not necessarily affluent ones) find themselves subjected to higher premium thresholds. In fact, a 40-year-old male of today with an annual salary of \$40,000 wishing to retire at 66 with an annual COLA of 3% could be earning more than \$86,000 per year by the time he is done working, which would indeed put him into the second means testing tier. Furthermore, HealthView's reporting system has found that upwards of 40% of current financial services clients, ranging in age from their late 40s to mid 60s, are expected to incur Medicare surcharges based on their future expected income.

It is important to note that means testing continues to be a hotbed topic on Capitol Hill, as additional legislation was recently passed that will actually lower income thresholds in 2018. What does this mean for future retirees? Millions more will experience Medicare surcharges as their MAGI vaults them into higher means testing brackets. (See Figure 1.)

The Power of the Roth

The only option to avoid surcharges (without reducing necessary income) is to address MAGI. The paradox of trying to reduce this type of income is that the average retirement saver continues to build wealth in the very investment vehicles, such as traditional IRAs and 401(k)s, that increase MAGI. Nobody is suggesting that investing in these accounts is a bad way to accumulate wealth, but given the fact that less than 50% of 401(k) plans offer the Roth option, and there is less than a 10% adoption rate in the plans that do offer it, it might be a good time to broach plan-design discussions with sponsors and provide new education possibilities for participants.

The Roth option in a 401(k) (or 403(b)) can also minimize exposure to unwanted RMD's for those ages 70½ and older. HealthView has termed RMDs the “silent killer” of retirement income planning. Here's why: one extra dollar of income from the wrong source can bump retirees into higher MAGI thresholds and trigger thousands of dollars in extra surcharges, which will remain for years to come. The normal decision of choosing the Roth option versus the traditional option really only addressed the question: “Will the client likely be in a higher tax bracket now or later?” With means testing on the rise, it would be a mistake to exclude this important variable from the planning process.

Consider the case of Mike, a worker who began investing at age 35 into his 401(k).

FIGURE 1: CHANGES IN MEANS TESTING THRESHOLDS

INDIVIDUALS THROUGH 2017	INDIVIDUALS STARTING IN 2018	COUPLES THROUGH 2017	COUPLES STARTING IN 2018
<\$85,000	No Change	\$170,000	No Change
\$85,001-\$107,000	No Change	\$170,001-\$214,000	No Change
\$107,001-\$160,000	\$107,001-\$133,500	\$214,001-\$320,000	\$214,001-\$267,000
\$160,001-\$214,000	\$133,501-\$160,000	\$320,001-\$428,000	\$267,001-\$320,000
\$214,000+	\$160,000+	\$428,000+	\$320,000+

“Upwards of 40% of current financial services clients, ranging in age from their late 40s to mid 60s, are expected to incur Medicare surcharges based on their future expected income.”

Mike is currently 55, has a desire to retire at age 65, and has determined, with the help of his advisor, that he will need \$161,000 per year to live on in retirement. Mike is lucky that he will retire with both Social Security and a pension — two sources that provide steady income (unfortunately, they also increase his MAGI). He will also be able to withdraw an additional \$83,000 per year from his defined contribution plan. As Figure 2 indicates, if Mike saves and withdraws from a traditional 401(k), that will push his MAGI over means testing thresholds and be subjected to an additional \$226,545 in Medicare surcharges over the course of his retirement.

In both cases, Mike will receive the needed income of \$161,000, but if he chose to withdraw from the Roth instead, he would only realize \$78,000 in MAGI. In simple terms, if Mike had simply chosen a Roth 401(k), he could have saved over a quarter of a million dollars in Medicare premiums during his retirement.

The Early Intervention Advantage

The 401(k) industry is the ideal setting to open discussions with investors on health care costs because the major advantage that retirement plan advisors have over all others is *early intervention*. By being able to engage workers at a young age, 401(k)s provide the ideal forum to educate participants in how to fund this future liability.


Ironically, the 401(k) industry may even be a good place to educate folks on how not to fund health care. A 2014 MFS survey of institutional clientele found that over 12% of loans from retirement plans were taken out to cover health care costs — an unfortunate side effect of a possible crisis in the making.

Health care cost analysis is a new concept in the retirement plan world, but one that is coming of age. In an industry where so much time and energy is dedicated to making decisions on investment selections based on a few basis points of differential on an expense ratio, or a few dozen basis points on a 10-year performance number,

it is hard to ignore the impact of what a 20,000 basis-point mistake might cost a client who ends up in the highest Medicare bracket rather than the lowest.

Means Testing Minimization

As an industry, we know that the exercise of selecting the proper strategy to increase monthly Social Security checks (“Social Security Optimization”) is a vital piece of the retirement puzzle. However, we believe that a new concept — “Means Testing Minimization” — is just as important to ensure that surcharges don’t consume all of that “extra” income.

Means testing minimization is just one approach that retirement plan markets can offer to help clients achieve financial security in relation to future medical expenses. 

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FIGURE 2: CASE STUDY

HEALTHY 35 YR. OLD MALE, RETIRES AT 65, LIVES UNTIL 86	ROTH 401K	TRADITIONAL 401K
Social Security	\$25,000	\$25,000
Pension	\$53,000	\$53,000
Annual Withdrawal from Retirement Plan	\$83,000	\$83,000
Total Income	\$161,000	\$161,000
Total Income (MAGI)	\$78,000	\$161,000
Income Band (Medicare Means Testing)	>\$85K	\$160K–214K
Healthcare costs throughout retirement	\$270,713	\$497,258

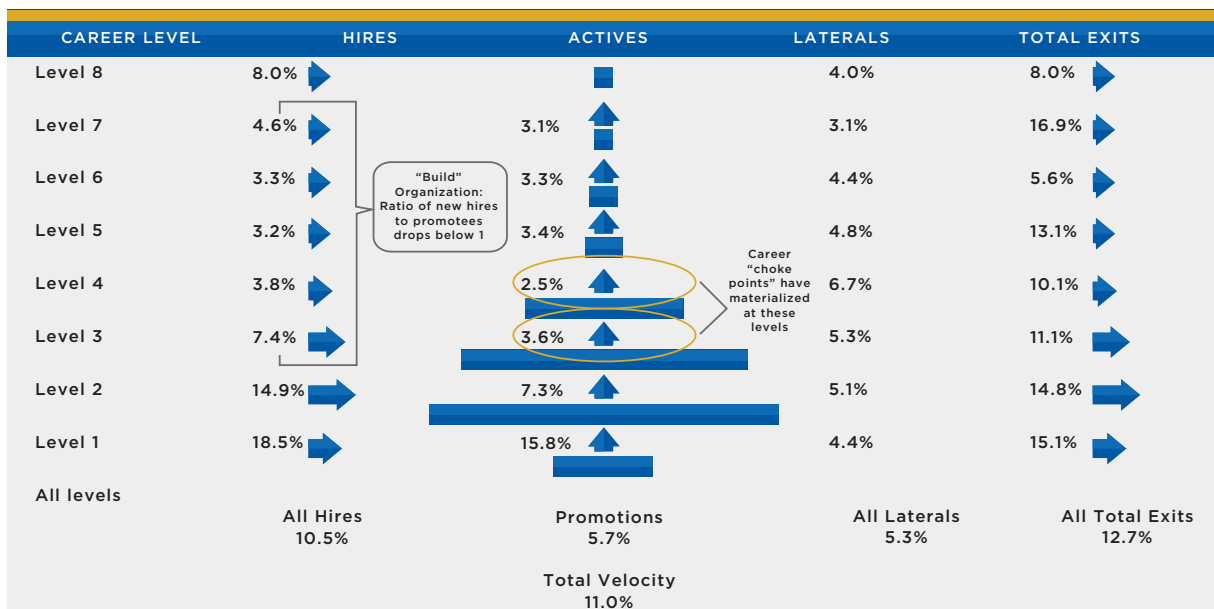
Source: HealthView Services – Health/Wealth Link



THE OUTCOMES ISSUE

BY THE NUMBERS

LIMITED INCENTIVES TO RETIRE — IN THE CONTEXT OF LOW GROWTH AND A “BUILD” TALENT STRATEGY — RESULT IN LOW INTERNAL LABOR MARKET VELOCITY, SIGNIFICANT CAREER CHOKE POINTS, AND A SERIOUS DRAIN OF TOP TALENT



Source: © 2014 Mercer

WHEN YOU IMPLEMENT AUTO ENROLLMENT, WHICH EMPLOYEE GROUPS WERE INCLUDED IN THE ROLLOUT?

	PLAN SIZE									
	Overall	<1MM	\$1MM-\$5MM	\$5MM-\$10MM	\$10MM-\$25MM	\$25MM-\$50MM	\$50MM-\$200MM	\$200MM-\$500MM	\$500MM-\$1B	>\$1B
New/Future employees	90.5%	65.7%	88.7%	91.7%	93.0%	93.2%	91.7%	91.7%	90.7%	92.0%
Existing employees not enrolled in plan	30.1%	31.4%	31.5%	28.6%	29.5%	34.0%	30.8%	28.6%	27.9%	30.7%
Employees enrolled in plan but contributing below the default rate (auto-boost)	14.9%	11.4%	6.5%	15.0%	16.0%	16.3%	17.2%	15.0%	7.0%	13.3%
Employees enrolled in plan but not invested in the QDIA	1.4%	2.9%	0.8%	0.8%	1.5%	1.4%	1.8%	0.8%	0.0%	1.3%
Other	2.9%	8.6%	3.2%	3.0%	1.0%	1.4%	4.1%	3.0%	4.7%	1.3%

Source: PLANSPPONSOR 2014 Defined Contribution Survey.