How to Keep Healthcare Costs from Ruining your Retirement

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While all good retirement plans factor a number of variables into their calculations – income, expenses, taxes, longevity – few issues, if any, are more important than the skyrocketing cost of healthcare. And Americans are starting to take notice.

A Mercer survey of American workers done in November, 2015, showed that workers are concerned about pension cuts and freezes, stock market volatility and changes to Social Security. But planning for healthcare expenses in retirement emerged as the fastest growing savings objective, cited by 32 percent of respondents, up from 24 percent in 2010.

Should you be skeptical about the gravity of the situation, recent history provides a glimpse of what may be on the horizon.

- According to the Department of Health and Human Services, spending on healthcare in this country increased 5.3 percent in 2014 (the most recent data available), the biggest jump since 2007.

- Thanks to the Affordable Care Act, federal spending on healthcare rose 11.7 percent in 2014, more than three times the 2013 increase.

- Retail spending on prescription drugs jumped 12.2 percent in 2014, the largest increase since 2002. (The numbers do not include prescription drugs administered in hospitals or doctors' offices, which are often high-cost specialty drugs.)

- In the 10-year period ending in 2025, national healthcare expenditures are expected to increase 5.8 percent per year on average, according to the Centers for Medicare & Medicaid Services.

- Healthcare costs are projected to rise twice as fast as Social Security's cost of living increases, meaning healthcare will be consuming a larger and larger portion of every American's Social Security check.

Impact on Americans

In its 2016 Retirement Healthcare Costs Data Report, HealthView Services projects what those numbers mean for the average consumer. (HealthView is a leading provider of healthcare cost tools and data to the financial and healthcare industries.)

The report contends that "the average healthy 65-year-old couple retiring this year is projected to spend $288,400 in today's dollars on lifetime Medicare Parts B (doctor visits and outpatient care), D (prescription drugs) and supplemental insurance (Plan F) premiums. When dental, hearing, vision and all other out-of-pocket expenses are included, the total retirement healthcare bill rises to $377,412." (The report assumed life expectancies of 87 and 89 for men and women, respectively.) "That could cost retirees about triple what they paid for coverage as employees," according to HealthServices.

Making matters worse, Social Security's cost-of-living adjustments are not keeping up with Medicare's growing costs. There was no COLA in 2009, 2010 and 2016. This year the COLA is 0.3 percent. In 2018 the Social Security Administration is projecting the COLA will be 2.2 percent, the highest since 2012. Looking further ahead, the Social Security Board of Trustees expects COLAs to increase no more than 2.7 percent per year on average. By comparison, the total average cost of Medicare is expected to rise 5.3 percent annually, nearly twice the COLA of Social Security. (The relationship between Social Security and Medicare is important to note because Part B premiums are almost always deducted directly from a recipient's Social Security check; having Part D premiums deducted from Social Security benefits is optional.)

According to the Motley Fool and Dan McGrath, co-founder of Jester Financial Technologies, the average Medicare recipient in 2016 paid about $4,300 to be fully covered by Parts B, D and F under Medicare. By comparison, the average retired worker is only receiving around $16,100 in annual Social Security benefits this year. This means Medicare payments are consuming 26 percent of retirees' Social Security income. However, with medical expense inflation outpacing national inflation measures, within 10 years seniors can expect to be paying 40 percent of their Social Security benefits to Medicare.

The HealthView report also put the Social Security issue into perspective. "A 66-year-old couple retiring this year will need 57 percent of their Social Security to cover total healthcare costs. A 55-year-old couple retiring in 10 years will need 88 percent, and a 45-year-old couple, 116 percent," according to the findings. "Americans will see a significant portion of their Social Security income consumed by healthcare costs; for some, medical expenses could eventually exceed their benefits," says Ron Mastrogiovanni, CEO of HealthView Services.

With no relief in sight to the soaring costs of healthcare, many financial advisors are re-thinking their views on income replacement ratios -- how much income someone will need to replace when they retire. Historically, the response has been that retirees will only need to replace about 80 – 85 percent of their pre-retirement income because a number of expenses go down or are eliminated entirely when you stop working. But Mastrogiovanni and HealthView think that percentage is too low, noting that healthcare expenses generally increase with age and that most retirees, now without employer-provided insurance, will be responsible for a larger portion of those costs. According to the HealthView report, "the stark reality is that healthcare is going to cost more than most retirees have saved using the traditional IRR-based plans."

Managing Medicare Costs

Millions of Americans save money by using Medicare instead of private healthcare insurance, but as you see Medicare costs are on the rise. The first thing to do to avoid unnecessary costs is to make sure you enroll in Medicare on time because missing the deadline is likely to result in a penalty. People who are newly eligible for Medicare because they are turning 65 have seven months in which to enroll. The enrollment period begins three months prior to the month they turn 65, and also includes the month of their birthday and the three following months. (People who are under 65 but qualify for Medicare because of a disability have longer enrollment periods.) You can also be penalized if you don't have a Medicare Prescription Drug Plan (Part D) or something equivalent for any period of 63 days or more after your initial enrollment period is over.

Aside from enrolling in a timely manner, the top recommendation of the Centers for Medicare and Medicaid services for lowering your costs is to do your research when choosing a Part D prescription drug plan. Part D premiums vary and premiums are only part of the story when it comes to total costs associated with a plan. Be specific when evaluating Part D plans. Is there a deductible that must be met before coverage kicks in? Are all *your* medications covered? What are the co-pays for each of the medications *you* take? Are there generic alternatives?

A second worthwhile exercise is to compare a Medicare Advantage plan to Original Medicare. Medicare Advantage plans are approved by Medicare but offered through private insurers. They may have elements you desire but are not offered under Original Medicare, such as capped annual out-of-pocket costs. Dental, vision and hearing coverage are also included in many plans.

Medicare Surcharge

Higher-income households are also required to pay a Medicare surcharge. The rates in 2016 were based on the modified adjusted gross income (MAGI) reported on your 2014 tax return. People who filed individual tax returns in 2014 with MAGI of over $85,000 (or couples with MAGI of over $170,000) will pay a surcharge. The basic surcharge also increases if other, higher, income thresholds are met.

If a significant portion of your income comes from investments, it may be possible to mitigate the chances you'll exceed the MAGI threshold and fall victim to Medicare's income-based surcharge. For example, income drawn from after-tax retirement vehicles such as Roth IRAs and Roth 401(k)s is not counted towards your MAGI. Similarly, income from a health savings account is also excluded from your MAGI, as is income from tax-preferred financial vehicles.

Health Savings Accounts (HSAs)

Because of its multiple advantages, one of the best ways to curtail healthcare expenses in retirement is to open a Health Savings Account. HSAs were created by the federal government in 2003 as a way to help individuals pay for medical expenses; they provide tax breaks on the money individuals set aside to pay for those expenses. While it may be too late for retirees, HSAs offer significant benefits to the next generation. Writing for Investment News, Katy Votava explains that “this type of account is the most tax-preferred vehicle we have in the United States today and an increasingly important retirement planning tool, because it provides a tax-free source of cash flow when spent on medical expenses in retirement.”

Increasingly, HSAs are being used in retirement planning because they offer several tax advantages; they provide both an upfront tax deduction and tax-free status when the money is used. “The best thing about HSAs from a tax perspective is that you are eligible to deduct the money you contribute to the account,” says the Motley Fool. “Most important, when you take distributions out of the HSA to cover qualified medical expenses, you don’t have to pay any tax on the withdrawn amounts.” The list of “qualified medical expenses” is extensive and generally mirrors the medical and dental costs that the IRS considers to be legitimate itemized tax deductions.

In addition to tax benefits, HSAs are effective tools for managing Medicare costs. As discussed earlier, higher-income households are required to pay a Medicare surcharge based on their modified adjusted gross income. HSAs can help avoid a surcharge because the money inside a HSA is not counted as part of MAGI. Better yet, contributions to a HSA do not have to be used in the year they are made. These funds can be invested with the interest and earnings allowed to grow tax-free.

Using HSAs to Save for Retirement

The advantages of HSAs makes them ideal vehicles for building a retirement nest egg. In some ways they are better than either a traditional IRA or a Roth IRA because HSAs offer the best of both. Contributions to a HSA go in untaxed and the funds can be invested and allowed to grow tax-free (like an IRA), and withdrawals for medical expenses come out untaxed (like a Roth IRA).

HSAs may be especially beneficial to younger individuals in good health. Because HSA contributions do not have to be used in the year they are made, the funds can be invested. Healthy individuals with minimal healthcare costs can allow the bulk of their HSAs to continue to grow year over year, decade over decade. The same advantage goes to individuals with the ability to pay their medical expenses from sources other than their HSAs. By not tapping their HSAs at all, everything they contribute can be allowed to grow.

In 2017, the maximum contributions to a HSA are $3,400 for individuals and $6,750 for families. People 55+ can also make an additional $1,000 catch-up contribution. Post-retirement, funds from an HSA remain tax-free if they are withdrawn to pay a medical expense. Individuals 65-and-older who use HSA funds for any other reason will have to pay income tax on the withdrawals, but no penalties. “HSAs are a great planning tool,” says Carolyn McClanahan, director of financial planning at a Florida financial firm. “They provide a triple tax whammy…and if you don’t use the money for medical, you can save it for retirement so you get tax-deferred accumulation, just like an IRA.”

In spite of their advantages, relatively few people use HSAs to save for retirement. According to a report by the Employee Benefit Research Institute, only 6.4 percent of HSA owners used the investment option in 2014. The reason is simply a lack of education. Historically, HSAs have been solely thought of as an alternative way of paying for healthcare. “A lot of people who have these accounts don’t know they can invest with them,” says Paul Fronstin, EBRI’s director of health research.

HSAs Restrictions

In spite of their advantages – or perhaps *because* of them -- the rules governing HSAs are numerous and complex.

The key restriction on HSAs is that they are only valid if you have an HDHP, a high deductible health plan, as your primary insurance coverage. (HDHPs typically have lower monthly premiums and higher annual deductibles than other insurance plans. They are designed to cover major medical expenses but provide little coverage for routine medical costs. As an example, a doctor’s visit for the flu probably will not be covered unless your deductible has already been met. Ryan Guina, founder of CashMoneyLife.com, explains “that is where a health savings account comes into play. A HSA is used in conjunction with a HDHP to pay for smaller, routine medical expenses like a doctor’s visit.” In 2017, in order for an insurance policy to qualify as an HDHP, its annual deductible must be at least $1,300 for an individual and $2,600 for a family. The maximum out-of-pocket-costs are $6,550 (individuals) and $13,100 (families). Many working individuals are barred from HSAs because the deductibles associated with their employer-provided insurance plan are too low.

Another significant potential drawback to HSAs surfaces when a policyholder turns 65. Individuals who take any part of Medicare can neither open a HSA nor contribute to an existing one. (That includes Part A which is automatically generated when a person takes Social Security.) However, individuals who continue to work and do not take any part of Medicare remain eligible for HSAs.

People under-65 who use HSA money for anything other than medical expenses must pay income tax plus a 20 percent penalty on the withdrawals. Once a person with an existing HSA starts on Medicare, you can use money from the HSA for purposes other than medical expenses without incurring a penalty. However, you will have to pay income tax on the funds, as if they were part of a traditional IRA.

A third barrier to opening an HSA is that it can be difficult to find a financial institution willing to open one on your behalf. Says the Motley Fool: "Many well-known institutions limit HSA participation to employees at companies for which the institutions provide benefit-management, such as 401(k) plan administration. Others don't offer HSAs at all."

Long Term Care

No discussion of preparing for healthcare costs in retirement would be complete without addressing the issue of long term care. As staggering as HealthView's medical expense projections are, the reality could be even worse because the estimates don't include the cost of long term care. And the cost of LTC can be devastating. The annual cost of a home health aide is about $45,800 according to a study by the Bipartisan Policy Center. The cost for community-based adult daycare centers is on average $16,900 per year. Writing for the Fiscal Times, veteran journalist Eric Pianin says that "in 2014… the average annual cost to live in a nursing facility was $87,600." It is estimated that 12 million Americans are currently in need of LTC services. And studies predict that 70 percent of Americans who reach 65 will need LTC at some point in their lives.

There are LTC insurance plans available to defray the costs, but the premiums are expensive and out of the reach of many families. LTC is also problematic for insurers because they find it difficult to price a product that will probably not be used for a long time. Advances in medicine have also made insurers fearful that their customers will live longer than expected while they are using LTC services.

Retirees who think Medicare will come to the rescue, need to think again. Medicare provides LTC support only in limited situations. Full benefits lapse after 20 days and partial support only lasts up to 100 days.

There are other options for funding long term care such as self-funding, Medicaid, and loans, but each has its drawbacks. For a full discussion of how to plan for your long term care needs, see our white paper on “How to Fund Long Term Care.”

- *To get a second opinion on your retirement outlook and portfolio, visit www.provestwealth.com or call 1-800-277-0025.*

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