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This month's newsletter discusses health-care changes and what it means to you in retirement. We think you'll find the article pertinent and informative, and we encourage you to forward the newsletter to any of your friends or relatives who may be interested in this topic.
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- Cornerstone Capital Advisors

5 Ways to Confront New Health-Care Costs in Retirement

Employer coverage is on the verge of major change that will leave retirees footing a larger share of the bill.

By Mark Miller

The cost of health care is one of the biggest out-of-pocket costs facing retirees--and for some, the challenge is getting tougher.

Fifteen million retirees on Medicare get supplemental health insurance coverage from their former employers--and another 2 million retirees not yet eligible for Medicare receive primary coverage from their former workplaces, according to research by the Kaiser Family Foundation (KFF). But employer coverage is on the verge of major change that will leave retirees footing a larger share of the bill.

For retirees over age 65, employer coverage typically supplements gaps in Medicare's coverage--paying for vision or dental care, capping out-of-pocket costs, or covering prescription drugs. For under-65 retirees, some employers provide primary health insurance.

But the number of employers covering retirees has declined sharply over the years, to just 28% in 2013, compared with 66% in 1988, according to KFF. Coverage levels took a sharp downward turn between 1988 and 1991, when the Financial Accounting Standards Board began requiring private-sector employers to reflect the benefit costs for current and future retirees as liabilities on their books. Since then, more employers have been dropping coverage due to the rising cost of health care.

Sudden changes are rare, so if you have a promised benefit from a former employer, it's not likely to disappear. More often, benefits are discontinued for newly hired workers.

New Trends in Employer Coverage

The declining coverage levels also reflect changes in the economy, notes Tricia Neuman, senior vice-president at Kaiser and director of the foundation's Medicare policy program. "Retiree health has typically been offered by large corporations in older industries," she says. "As new companies come on the scene, they're less likely to offer retiree health care from the start."

But many employers that continue to provide health benefits are restructuring their programs for current and future retirees. The big trend is the shift to a defined-contribution model, where retirees receive a specific amount toward buying a plan, often in a private insurance exchange offering a range of policies. Earlier this year, AT&T made news when it announced plans to move its Medicare-eligible retirees to a private insurance exchange in 2015, following similar moves by IBM and Time Warner.

The change can be unsettling for retirees accustomed to receiving a defined-health benefit and who now need to navigate more complex choices in an insurance marketplace. However, most of the private exchange offerings include one-on-one advice and guidance services aimed at helping retirees make optimal insurance choices.

But the change to marketplace coverage does shift cost risk from the employer to retirees--and it follows a period where out-of-pocket costs have risen sharply. Kaiser reported recently that between 2000 and 2010, average annual total out-of-pocket spending among beneficiaries in traditional Medicare increased by 44%, to $4,734. During that time, total out-of-pocket costs increased at an average annual growth rate of 3.7%.

Health-care cost inflation has been quiet lately. Fidelity Investments, which publishes an annual report on retiree health-care costs, reported last month that a 65-year-old couple retiring this year will need to have saved $220,000 to meet health-care expenses during their retirement--the same estimate the company made last year. And Fidelity's 2012 forecast reflected an 8% drop in projected costs. (Fidelity includes Medicare premiums, deductibles, and coinsurance in its totals but excludes any long-term care expense, over-the-counter medications, and dental care. The forecast assumes 20 years in retirement for women and 17 for men.)

Those figures reflect a slowdown in Medicare's own cost growth. Medicare's trustees said last week that the monthly premium for Part B (outpatient services) will stay at $104.90 in 2015 for the third consecutive year; separately, the federal government forecasts that average monthly Part D (prescription drug) premiums will rise just $1, to $32 next year. Average premiums have been right in that range for the past four years.

Impact of the Affordable Care Act
For retirees younger than 65, the erosion of employer coverage used to be a major headache. Their main option was to buy an individual insurance policy, and they could be turned away by insurance companies due to pre-existing conditions, or face high prices for insurance policies offering weak coverage.

That has changed dramatically with the implementation of the Affordable Care Act (ACA). Under the ACA, these retirees have access to policies through the new public insurance exchanges with tightly regulated benefits, and they cannot be turned away for pre-existing conditions. "People in their late 50s and early 60s who lost group coverage were left high and dry," Neuman says. "The ACA is a game changer."

Some experts think employers who continue to provide coverage to under-65 retirees may start moving them onto the ACA exchanges with a subsidy to cover costs. The trend hasn't kicked into high gear yet because many are evaluating the new exchanges.

Managing Costs
Still, it's a fair bet that many retirees with benefits from former employers can expect to bear a bigger share of costs in the years ahead. Here are some strategies that can help counterbalance the increased burden.

1. Save with tax-efficiency: It goes without saying that some portion of your retirement nest egg will be spent on health care. But one savings vehicle is shaping up to be especially well-suited for building a health-care nest egg: health saving accounts (HSAs). Access to these accounts usually comes alongside high-deductible insurance plans, which are rapidly gaining popularity among employers. Employers and employees make tax-free contributions to the accounts, and balances can be used to meet deductibles. But HSA balances also can be rolled over from year to year, and the accounts are portable. Accumulations and withdrawals also are tax-free.

The Internal Revenue Service limits total contributions by employers and workers to $3,300 for individuals or $6,550 for family coverage. And accumulations in these accounts are small now--the average balance last year in HSAs held at Fidelity Investments was just $3,114. But some experts argue that a significant number of workers will be able to accumulate significant HSA accounts by retirement in the years ahead, giving them a tax-free resource for meeting rising health-care expenses.

Roth IRAs are another reasonable option for tax-advantaged savings to meet anticipated health costs in retirement. The big advantage here: Roths are not subject to required minimum distributions in most cases, and most withdrawals also are not subject to taxes.

2. Work longer: It's not an option for everyone, but a few additional years of work means fewer net years paying Medicare premiums and more years on your employer's health insurance plan. If you work past age 65, your employer's coverage remains primary if you work for a company with 20 or more employees; at smaller firms, Medicare's coverage is primary.

3. Delay filing for Social Security: Your benefit amount is calculated using a formula called the primary insurance amount, or PIA. Claimants who wait to start Social Security until their full retirement age (currently 66) receive 100% of PIA; taking benefits at 62, the first year of eligibility, gets them 75% of PIA. By waiting until age 70 (the maximum year for delayed filing credits), they'll receive 132% of the PIA. And those benefits are enhanced by an annual cost-of-living adjustment, which is added in for years of delayed filing.

Filing later means higher annual income for life, which can be a great hedge against high health-care expenses--not to mention the risk of running out of money in old age. Couples can boost their combined benefits further by executing a file-and-suspend strategy.

You can finance living expenses while you wait by working longer or by drawing down retirement savings. Research shows that the latter strategy actually boosts portfolio longevity.

4. Choose Medicare plans carefully. Medicare offers two basic coverage options: traditional fee-for-service or Medicare Advantage, which is a managed-care alternative that offers all-in-one coverage for hospitalization, outpatient services, and (often) prescription drugs.

You may be able to save money by joining an Advantage plan, and nearly 30% of eligible Medicare beneficiaries now use this option. When you join an Advantage plan, Medicare provides a fixed payment to the plan to cover your Medicare Part A (hospital) and Medicare Part B (medical insurance) coverage. There may be additional copayments and deductibles, depending on the type of plan you join, but your total annual out-of-pocket costs are capped. Many Advantage plans also offer--and charge for--supplemental benefits such as vision, hearing, and dental care.

Tradeoffs to consider: You are agreeing to use physicians in the Advantage plan's provider network. It's also critical to take a close look at the plan's prescription-drug coverage to make sure it will cover your medications without additional expense or qualification hassles.

The alternative is traditional fee-for-service Medicare. You'll be able to use virtually any health-care provider; you'll need to sign up for a Part D prescription-drug plan and will probably want a Medigap supplemental plan, which helps cover out-of-pocket costs.

5. Watch out for premium "brackets." High-income households pay more for Medicare--and for policies bought through the ACA exchanges. In both cases, careful income planning can save you money on insurance premiums.

In the Medicare program, premium surcharges are applied to Part B and Part D. The surcharges affect individuals with more than $85,000 in annual income and joint filers with total annual income of more than $170,000. The surcharges start at $42 per month, and run up to $231 monthly for the highest-income seniors. The Social Security Administration determines who pays the premium surcharge using recent tax returns. Eligibility is determined on the basis of modified adjusted gross income (MAGI), which includes adjusted gross income and tax-exempt interest income.

Few seniors have MAGI in that range, since most are retired. But with more people working past age 65, a growing number of beneficiaries will trip the wire in the years ahead--and the numbers also will grow due to changes in the formulas contained in the Affordable Care Act. Finally, policymakers in Washington ranging from Rep. Paul Ryan (R-Wisconsin) to President Obama have proposed further expansion of high-income surcharges.

For under-65 retirees, the ACA exchanges offer tax credits to offset the cost of insurance. The credits are available to families with incomes between 100% and 400% of the federally defined poverty guideline. At 400%, families aren't required to spend more than 9.5% of income on premiums.

But the credits vanish at the top of this scale. This year, they're available for individuals with annual income between $11,490 and $45,960, and from $23,550 to $94,320 for a family of four. (The MAGI income definition used here includes wages, salary, foreign income, interest, dividends, and Social Security benefits.)

About the Author
Retirement columnist Mark Miller writes about trends in retirement, aging, and the economy. He is the author of The Hard Times Guide to Retirement Security: Practical Strategies for Money, Work and Living and writes a syndicated column for Reuters. Mark blogs at RetirementRevised.com. Twitter: @retirerevised.