How Retirees Can Benefit from the New Health Care Laws
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Earlier this year, my colleague Tom McGuigan elegantly described a new type of income inequality in America. This one arises solely from the application of the Affordable Care Act, or, under the popular lexicon, Obamacare.

Tom observed that younger people who receive mostly wage income are likely to pay significantly more for individual health insurance coverage than retirees who have the flexibility to manipulate their taxable income. If you're in retirement or approaching it, can you take advantage of this opportunity, and if so, how?

To answer that question, it is helpful to understand some nuances with the Affordable Care Act. In an effort to make health insurance more affordable, a premium assistance tax credit[1] was introduced to reduce the cost of insurance for households with income below certain limits. For example, the income[2] limit for a household of two is around $62,000. A young married couple without children may not be able to keep their income this low simply because of their salaries. However, a married retired couple under age 65 may find it much easier to qualify for the premium assistance if they're willing and able to keep income low enough. Of course once this couple reaches age 65, they would qualify for Medicare and switch to that.

To illustrate the planning opportunity with premium assistance, consider a married couple in Oklahoma City both turning age 60 and retiring at the beginning of next year. They have $3.5 million in investable assets and no debt. The breakdown of assets is $2.2 million in IRAs, $1.0 million in a joint taxable account and $300,000 cash & CDs in a bank account. They would like to spend $100,000 per year after tax to meet their lifestyle goals and need to rely on their portfolio for income as there are no pensions.

If this couple needed to obtain health insurance, they could use the newly created exchange and apply for coverage. Should they want the lowest cost "platinum" plan, they would have to pay a monthly household premium of around $1,640. Note this would be a full coverage plan[3] with $0 deductible and $2,000 maximum out-of-pocket expenses.

With a traditional retirement income strategy, they might fund their lifestyle with $75,000 IRA distributions and take the rest from their taxable accounts and cash. But if they did this, the income they would report on their tax return would be too high to qualify for premium assistance tax credits.

Instead, what they can do is structure their distributions and capital gain decisions throughout the year so their income is no more than $62,040 (2014 threshold). If they can do this, they qualify for a monthly credit of $363 or annual premium savings of $4,366. Remarkably, if they report just one additional dollar of taxable income, the credit gets completely eliminated!

To look at it another way, this couple's effective tax rate has a major spike at that income threshold. An additional $400 of taxable income over the threshold is like increasing the tax rate by a whopping 1,000 percent. As a result, an intelligent tax plan in this scenario would be to either stay under the $62,040 threshold or to make sure to be significantly above it.

It's worthwhile to note that any strategy where taxable income is purposely kept low should be considered carefully to make sure short-term benefits outweigh long-term consequences. Those following this strategy may find it more appealing to delay claiming Social Security benefits until they are 65 or older. While often good for longevity protection, it can put more strain on investment portfolio in early years of retirement. Also, minimizing taxable income too much in early retirement years can risk shifting a larger tax burden to later years. Advisors must carefully look at the tradeoffs.

The strategy described in this piece is best-suited for retirees who have good tax diversification in their assets. For example, if your assets consist mostly of tax deferred IRAs, this strategy is likely to be less impactful. Likewise, if taxable accounts are a large portion of your retirement assets, it might be harder to control taxable income in the first place, thus making you ineligible for the lower health insurance premiums. In the end, having a good balance of taxable, tax deferred and tax free enhances the efficacy of this approach.

This commentary is not meant to suggest we all change our financial plans. Rather, the lesson is that understanding the interplay among desired cash flow, taxes, withdrawal strategies and healthcare costs is a key component of retirement planning. The Affordable Care Act does present another planning consideration for a select segment of retirees.

As financial advisors, we try to keep our eyes open to new money-saving strategies for clients. Taking advantage of health insurance premium credits might sound a bit unconventional, but we think it should at least be considered in tax planning discussions for early retirees.

1. http://www.hhs.gov/healthcare/rights/
2. Not a typical tax credit that is paid directly to taxpayers, but instead to new health insurance exchange (insurer) and taxpayer is billed for reduced premiums immediately.
3. For the technical reader, the income definition used is Modified Adjusted Gross Income (modified AGI).

4. Assumes household of 2 non-smokers, no dependents, and filing a joint tax return. Website used for premium information: http://www.valuepenguin.com/ppaca/exchanges/ok