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Healthcare Reform Implications on the Municipal Market

March 2010

In 2009, President Obama and the Democratic leaders of Congress moved to create a comprehensive national system of health insurance. On November 7, 2009, the House of Representatives approved a sweeping overhaul of the nation's health care system by a vote of 220 to 215. The Senate passed an 841 billion dollar bill on December 24, 2009. These bills would expand medical coverage by increasing Medicaid eligibility for lower income people and by offering insurance subsidies to help moderate income people. The proposed bills would forbid insurance companies from denying coverage to people with pre-existing conditions; furthermore, these bills would create insurance exchanges, i.e. new government regulated marketplaces where individuals and small businesses could come together to buy coverage. The 160 million Americans who get their coverage through their employer would be permitted to retain that insurance. Nearly everyone would be required to buy insurance or incur a penalty; businesses would be required to provide employee coverage or contribute their premium costs.

Pushing for a bill that could transform the nation's health-insurance system, House leaders announced a $940 billion compromise on March 18, 2010, that would extend coverage to virtually all Americans, cut billions of dollars from Medicare, and impose new taxes on the wealthy and the well-insured (Cadillac Plans).

According to the new bill, coverage will be extended to an additional 32 million Americans over the next decade by expanding Medicaid eligibility and creating state-run insurance exchanges and federal subsidies for lower-income families who lack access to employer-provided coverage. For the first time in the history of this country, all Americans will be required to obtain insurance or face an annual penalty of $695; employers can face penalties of up to $2,000 per worker for not offering “affordable” coverage. In exchange for the new business, private insurers will be subject to an array of rules, including a ban on the practice of denying coverage to people with pre-existing medical conditions; furthermore, they will have to allow adult children to remain on their parents' policies until age 26.

In comparison to the Senate bill, this new bill will offer more generous tax credits to people who may otherwise be unable to afford insurance and will fully close the costly gap in the Medicare prescription drug program, beginning with a $250 rebate this year for affected seniors.
To cover the cost of these changes, the bill will impose a 3.8 percent Medicare tax on investment income for wealthy taxpayers, i.e. individuals earning more than $200,000 a year and couples earning more than $250,000; said wealthy taxpayers would also incur an additional levy in regular payroll taxes under a Senate proposal. The bill will slice an additional $60 billion from Medicare, with the privately run program known as Medicare Advantage targeted for particularly deep cuts, bringing the total reduction in projected spending on the program to more than $500 billion over the next decade.

Positive Implications for Tax-Exempt Securities

When the Administration’s Health Care Reform package is enacted, one provision could make tax exempt municipal bonds more attractive in comparison with taxable alternatives. One of the planned revenue sources for the package is a maximum 3.8% tax on investment income, to begin in 2013. Under this provision, the new maximum tax rate would apply to income from taxable interest, dividends, annuities, royalties, capital gains and rental income for individuals who earn more than $200,000 annually and couples reporting more than $250,000. The maximum tax rate on fully taxed investment income, such as taxable bond interest, would max out at 43.4%, as compared to the current 35%.

The tax would be implemented in two stages:

- In 2011, the maximum tax rate on ordinary income would climb back to 39.6% as the Bush tax cuts expire.
- In 2013, the Medicare tax would be imposed.

This bill creates further tax challenges for high-income earners, in addition to those already proposed. Congress will likely allow the Bush administration tax cuts to expire for couples who earn more than $250,000 a year, meaning that the top income tax rate will rise to 39.6% from 35%; the second-highest rate will rise to 35% from 33%. Furthermore, Congress is considering a budget proposal to reduce itemized deduction write offs for couples who earn more than $250,000 a year, effectively raising their tax rates. Additionally, without congressional action, the estate tax in 2011 reverts to 2001 levels, a 55% maximum rate after the exemption for the first $1 million. This reversion will exacerbate the already complex tax code, complicating the lives of high-income taxpayers and their financial advisers.

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