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Means-Testing Medicare: Retiree Pain for  
Little Governmental Gain

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# Means-Testing Medicare: Retiree Pain for Little Governmental Gain

Richard L. Kaplan

## Abstract

Medicare Part B covers most doctors' fees, diagnostic tests, ambulance services, and certain other items. Enrollees pay a monthly premium that is calculated to cover 25 percent of the program's expenditures, with the remaining 75 percent coming from general governmental revenues. But starting in 2007, this cost-sharing ratio will be increased for retirees whose annual taxable income exceeds \$80,000. This means-testing of Medicare was adopted in the mammoth 2003 Medicare Act that also provided coverage of prescription drugs and was accelerated by the Deficit Reduction Act that was enacted in February 2006. This article examines the decade-long policy debate about means-testing Medicare and explores the tax implications of the mechanism that was finally created. The article also analyzes concerns about the joint administration of this program by the Social Security Administration and the Internal Revenue Service, and discusses such financial ramifications for upper-income retirees as capped contributions from former employers and possible nonenrollment in Medicare Part B.

Medicare Part B covers most doctors' fees, diagnostic tests, ambulance services, and certain other items. Enrollees pay a monthly premium that is calculated to cover 25 percent of the program's expenditures, with the remaining 75 percent coming from general governmental revenues. But starting in 2007, this cost-sharing ratio will be increased for retirees whose annual taxable income exceeds \$80,000. This means-testing of Medicare was adopted in the mammoth 2003 Medicare Act that also provided coverage of prescription drugs and was accelerated by the Deficit Reduction Act that was enacted in February 2006. This article examines the decade-long policy debate about means-testing Medicare and explores the tax implications of the mechanism that was finally created. The article also analyzes concerns about the joint administration of this program by the Social Security Administration and the Internal Revenue Service, and discusses such financial ramifications for upper-income retirees as capped contributions from former employers and possible nonenrollment in Medicare Part B.

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# Means-Testing Medicare: Retiree Pain for Little Governmental Gain

*By Richard L. Kaplan*

Richard Kaplan explains the implications of the new Medicare Part B means-testing and how this new development must be considered in future income planning.

**M**ost retirees know that they pay a monthly premium for Medicare Part B coverage. In 2006, this premium is \$88.50,<sup>1</sup> and it is commonly deducted from the retiree's monthly Social Security benefit. But most retirees and their advisors do not realize that in 2007, this premium will begin to rise dramatically for certain Medicare enrollees who have "high" annual income as reported for federal tax purposes. This article considers this mechanism of "means-testing" Medicare Part B and explains how it provides another reason why affected retirees will want to minimize their taxable income.

## How Medicare Is Financed

Whenever an American has income from wages, salaries or self-employment, that person pays a Medicare payroll tax of 1.45 percent on that income.<sup>2</sup> For employees, this 1.45-percent tax is matched by a comparable 1.45-tax paid by the employers,<sup>3</sup> though in practice, employers typically remit both the employee and employer portions.<sup>4</sup> Self-employed individuals act as their own employers and pay a combined payroll tax of 2.9 percent<sup>5</sup> through their regular income tax filings, including quarterly payments of estimated tax. In both circumstances, the Medicare payroll tax is assessed on *all* earned income, without any reference to the familiar an-

nual cap (\$94,200 in 2006)<sup>6</sup> that applies to Social Security taxes.

This payroll tax is designated for the Medicare program, but it actually funds only one part of Medicare coverage—so-called Medicare Part A. This coverage pertains to hospitalizations, skilled nursing facility care, home health agency services and hospice care.<sup>7</sup> Each of these coverage elements is subject to a variety of restrictions and limitations that are often significant. For example, hospitalizations have a deductible of \$952 (in 2006)<sup>8</sup> per "spell of illness," a period that typically runs until the patient has been out of a hospital or nursing home for 60 consecutive days.<sup>9</sup>

## Entitlement to Medicare Part A

A person becomes entitled to Medicare Part A when he or she becomes 65 years old and is eligible to receive Social Security retirement benefits.<sup>10</sup> This latter requirement is satisfied by the person having earned at least 40 "quarters of coverage" throughout his or her working life.<sup>11</sup> A "quarter of coverage" is a measure of employment and in 2006 required earnings of \$970.<sup>12</sup> A person can earn no more than four "quarters of coverage" in any given calendar year, so the requirement of 40 "quarters of coverage" usually translates into a requirement that a person work at least 10 years to receive Medicare Part A.

Both requirements must be met. That is, a person who is receiving Social Security retirement benefits but is not yet 65 years old is not eligible for Medicare Part A. The Medicare program, in other words, has no "early retirement" option, unlike Social Security,

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which can provide retirement benefits as early as 62 years of age.<sup>13</sup>

As is the case with any government program, there are special rules for particular circumstances. For example, a person can satisfy Medicare's work requirement, even if he or she never held a position in the compensated workforce, if that person's spouse met the 40 "quarters of coverage" test.<sup>14</sup> Moreover, a divorced spouse can qualify as a spouse for this purpose if the marriage lasted at least 10 years.<sup>15</sup> On the other hand, Medicare is a federal statute so the definition of a "spouse" is limited by the Defense of Marriage Act "to a person of the opposite sex who is a husband or wife."<sup>16</sup>

But once a person meets the age-65 and the work requirement, Medicare Part A is available without further charge. In effect, entitlement to this program is prepaid by the enrollee during his or her working career. And if a person continues to work after age 65, that person's employer usually insists that this person enroll in Medicare Part A because no further cost is required to obtain its benefits.

## Medicare Part B Coverage and Financing

A very different situation presents itself with respect to Medicare Part B. This coverage applies to doctors' fees, whether in a hospital or in a doctor's office, as well as diagnostic tests, ambulance services and certain other items.<sup>17</sup> In contrast to how Medicare Part A is financed, Medicare Part B involves no payroll tax or other pre-funding mechanism. Instead, the government estimates how much the covered services will cost in the coming year and assesses a monthly premium to cover a portion of these estimated costs. The remainder of the estimated costs is paid out of general federal revenues, which means—primarily—federal income taxes on individuals and corporations.

The exact ratio of enrollee premiums and general tax revenues has varied over the years, but for the past two decades, it has been 25 percent from enrollee premiums and 75 percent from general tax revenues.<sup>18</sup> As a consequence, Medicare Part B is a relative bargain to enrollees because the federal government is subsidizing its cost to the tune of 75 percent. It is not surprising, therefore, that almost all persons who are eligible for Medicare Part B coverage take it<sup>19</sup> and pay the associated premium, though in some cases former employers cover this cost as a retiree health benefit. But the bottom line is that the monthly premiums

that Medicare enrollees pay for Part B covers only 25 percent of the program's projected costs.

## The Means-Testing Debate

For some time, a debate has simmered in this country whether taxpayers ought to shoulder 75 percent of the cost of Medicare Part B. As a group, Americans aged 65 years and older have more disposable income and greater unencumbered wealth than do Americans under age 65. Such categorizations, of course, gloss over huge variations in both age groups, but a policy question has persisted about whether Medicare enrollees should pay more for Medicare Part B coverage based on their annual income. Some enrollees effectively do pay more for their Medicare Part A coverage, because that program is funded by the payroll tax considered above. Medicare Part A's payroll tax ensures that a retiree whose average annual income before retirement was twice that of some other retiree will have paid twice the amount of Medicare payroll tax that the other retiree paid while becoming entitled to the same package of benefits. Given this situation, it is somewhat anomalous, some people have contended, that Medicare Part B makes no distinction among retirees on the basis of their income or wealth.

## Previous Means-Testing Proposals

Proposals to differentiate Medicare Part B premiums according to a retiree's annual income are nothing new. One such proposal was made during the administration of President George H.W. Bush<sup>20</sup> and was subsequently incorporated into President William J. Clinton's ill-fated "Health Security" proposal of 1993.<sup>21</sup> Variations on this theme of "means-testing" Medicare Part B—*i.e.*, charging higher monthly premiums to higher-income retirees—were included in many of the alternative plans that appeared during the health care reform debate of 1993–1994.<sup>22</sup> In fact, the concept of means-testing Medicare Part B was actually adopted, with somewhat different income thresholds and cost-sharing formulae, in the Balanced Budget Act of 1995<sup>23</sup> that President Clinton vetoed, an act that precipitated the famous government "shut-down" of 1996. Means-testing Medicare made still another appearance in the version of the Balanced Budget Act of 1997<sup>24</sup> that passed the U.S. Senate, but this provision was eliminated in the conference committee that reconciled the House and Senate versions of that legislation.

## Social Insurance vs. Welfare

This checkered history of means-testing Medicare Part B reflects some major philosophical divides in American politics. These divides were most apparent in the debate on this issue that took place in the U.S. House of Representatives in 1997. It was the House conferees, after all, who rejected the Senate’s attempt to calibrate retirees’ Medicare Part B premiums according to their income.

At the risk of over-generalizing the debate, it can be noted that Democrats in the House opposed means-testing Medicare because they thought that such a concept was contrary to the social insurance role that they wanted Medicare to play. Democrats wanted everyone to be in the Medicare risk pool and wanted the program’s benefits to be shared as broadly as possible. This approach was undoubtedly a reaction, in part, to what had happened the year before when the Personal Responsibility and Work Opportunity Reconciliation Act<sup>25</sup> (better known as welfare reform) was passed. That is, House Democrats opposed means-testing Medicare Part B because they were concerned that if Medicare Part B began to take on certain characteristics of a

welfare program—*e.g.*, fewer benefits (or higher costs) for persons with greater income—then Medicare might become vulnerable to the sort of attack that federal welfare programs had endured the previous year.

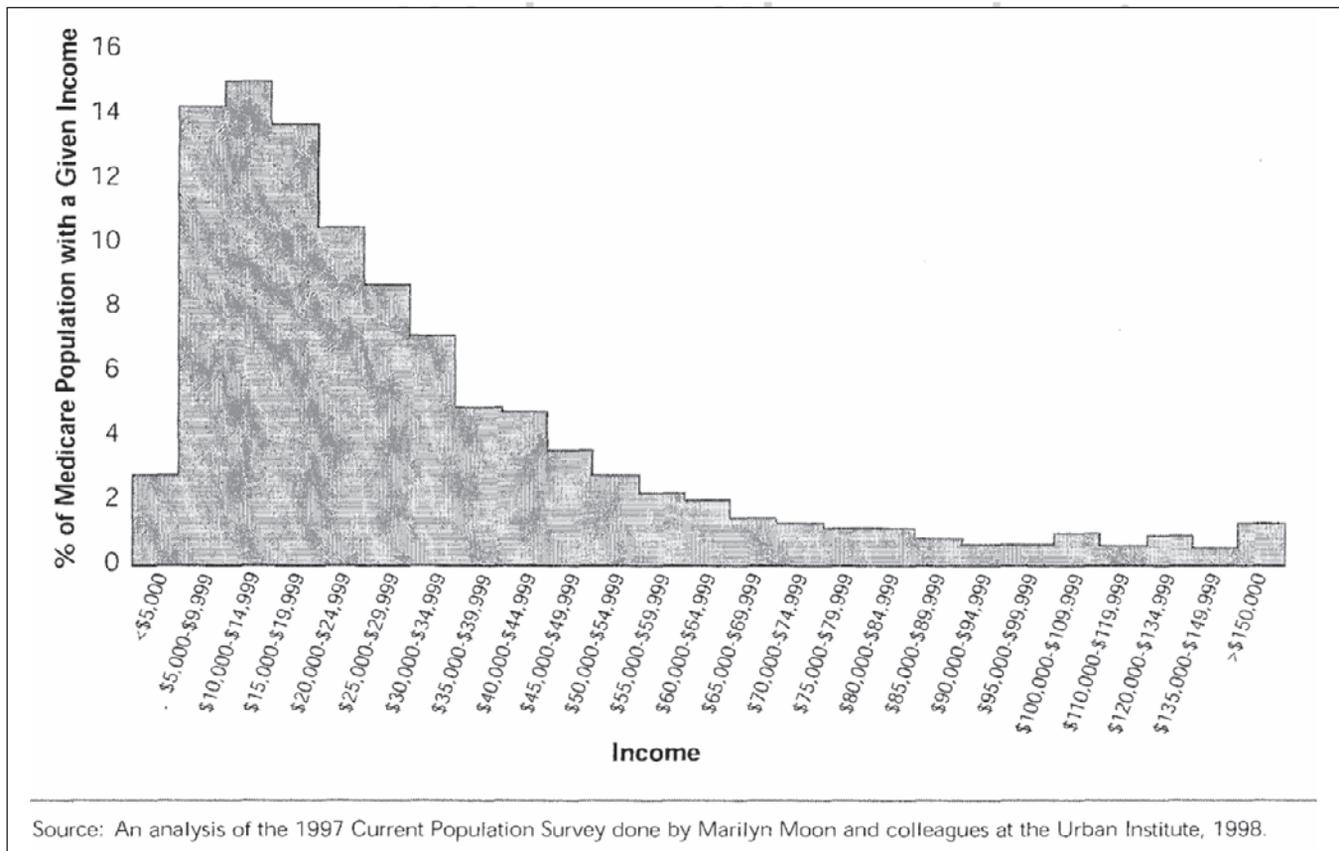
## Penalizing the Successful

Interestingly, the Republicans in the House of Representatives *also* opposed means-testing in Medicare Part B, but for a very different reason. House Republicans believed that calibrating Medicare Part B premiums according to income was a back-door tax on retirees who had worked and invested conscientiously throughout their working lives. In other words, means-testing Medicare was just one more penalty on effort or a “success tax” in their view. Accordingly, House Republicans opposed means-testing Medicare Part B to avoid imposing a stealth tax on upper-income retirees.

## Risk of High-Income Opt-Outs

Apart from these political assessments, the basic notion of means-testing a medical insurance program

**Chart 1 Projected Family Income Distribution of Medicare Beneficiaries, 1998**



like Medicare Part B is somewhat problematic. Most studies show that folks who have higher incomes are generally healthier than folks who have fewer financial resources at their disposal, and this relationship applies to retirees as well. Thus, the upper-income retirees who would be paying the most under a means-testing scheme are likely to be among the enrollees who receive the least direct benefits from the program. Taken to the extreme, if upper-income enrollees are asked to pay the full cost of their coverage, some retirees might opt out of Medicare Part B and obtain private health insurance to cover the services that this program provides. Medicare Part B, after all, is a voluntary program—with premiums that are heavily subsidized, to be sure, but a voluntary program nonetheless.

To the extent that high-income nonenrollees represent lower-than-average health care risks, Medicare Part B could face a classic adverse selection problem. That is, as lower-risk enrollees leave the program, Medicare Part B's expenditures net of enrollee premiums would increase, and premiums going forward would necessarily rise. In other words, means-testing Medicare Part B might actually boomerang and result in higher premiums being paid by the remaining, mainly lower-income enrollees and higher costs borne by the federal government. "Soaking the rich" in a voluntary health insurance program could therefore become a singularly ineffective strategy.

## **Income-Distribution Paradox**

The prospect of means-testing Medicare Part B runs into another problem relating to the distribution of income. Among Americans aged 65 years and older, the majority have annual income of less than \$35,000, as shown in Chart 1.<sup>26</sup> So, if means-testing Medicare Part B premiums is to have any noticeable impact on government expenditures, it must apply at a fairly low income threshold. But at a low income threshold, the plan is politically disastrous because too many people would be directly affected. Congress learned that lesson in 1988 when it imposed a broadly applicable income-based tax increase on older Americans to help finance Medicare.<sup>27</sup> Enraged senior citizens literally attacked Congressmen in their cars for enacting this additional tax and forced its complete repeal the following year.<sup>28</sup> On the other hand, if the income threshold is raised high enough to avoid a political backlash, the means-testing mechanism will affect relatively few older Americans and will therefore

bring in fewer revenues. As a result, means-testing's significance will be more symbolic than economic. It is against this background that the new means-testing of Medicare Part B must be considered.

## **Means-Testing in 2007**

The new provision that will means-test Medicare Part B was included in the mammoth Medicare Prescription Drug, Improvement, and Modernization Act of 2003.<sup>29</sup> This law was signed with much fanfare by President George W. Bush, who pushed strongly for its enactment of prescription drug coverage under newly created Medicare Part D. In a separate article entitled *The Medicare Drug Benefit: A Prescription for Confusion*, I analyzed the curious design and problematic feature of this new addition to the Medicare program,<sup>30</sup> but that drug benefit was only part of this new law. (Another part, unrelated to Medicare, was the creation of Health Savings Accounts.<sup>31</sup>) This law also included a means-testing provision entitled "Income-Related Reduction in Part B Premium Subsidy."<sup>32</sup>

This somewhat Orwellian phrase increases the monthly cost of Medicare Part B to high-income retirees according to their income as reported for federal tax purposes. This provision separates retirees into five income categories and phases in the increased cost (by reducing the premium subsidy) starting in 2007.<sup>33</sup> As enacted in 2003, this phase-in was to occur in five even steps from 2007 to 2011.<sup>34</sup> But the Deficit Reduction Act of 2005,<sup>35</sup> which was actually enacted on February 8, 2006, shortened this phase-in period to only three years.<sup>36</sup> Accordingly, the full impact of this provision will be felt two years earlier than was the case when it was originally legislated. Chart 2 provides the newly revised cost-sharing percentages that will apply to Medicare Part B enrollees starting next year. Note that the income parameters in Chart 2 are for single individuals. For married couples who file jointly, the income parameters are doubled.<sup>37</sup> Thus, the no-change

**Chart 2**

Income Level	Cost-Sharing Percentage		
	2007	2008	2009
< \$80,000	25	25	25
\$80,001 - \$100,000	28.3	31.7	35
\$100,001 - \$150,000	33.25	41.75	50
\$150,001 - \$200,000	38.2	51.8	65
> \$200,000	43.15	61.85	80

category would involve income under \$160,000 for married couples, while the highest tier would apply to couples whose income exceeds \$400,000.

**Example 1.** In 2007, assume that the regular Medicare Part B premium will be \$100, representing 25 percent of a projected monthly cost of \$400. Donald is unmarried and his income is \$145,000, so his cost-sharing percentage is 33.25 percent in 2007. Accordingly, he will pay 33.25 percent of the \$400 monthly cost, or \$133, instead of the \$100 that would be due if this means-testing provision had not been enacted.

**Example 2.** Donald's income is still \$145,000 but the year now is 2009, and the regular Medicare Part B premium is \$140, implying a projected monthly cost of \$560. Since Donald's cost-sharing percentage is 50 percent in 2009, he will pay \$280 (\$560 x 50%) per month instead of \$140. And if his income that year had been \$201,000, his cost-sharing percentage in 2009 would have been 80 percent, and his monthly Medicare Part B premium would have been \$448 (\$560 x 80%). In that situation, he would be paying an extra \$308 per month (\$448 – regular premium of \$140) for his Medicare Part B benefits, an increased annual cost of nearly \$3,700 due to the means-testing provision.

### Income Parameter Indexation

The income parameters in Chart 2 apply to the year 2007 and are to be indexed for inflation after that year.<sup>38</sup> But even before this means-testing provision takes effect, President Bush has proposed that its income indexation feature be eliminated! His 2007 *Budget Message of the President* explains this change as follows: "In order to strengthen [Medicare]'s long-term fiscal sustainability, the Budget proposes to broaden the applicability of reduced subsidies for higher-income beneficiaries."<sup>39</sup> No further explanation or justification is provided in the more detailed *Major Savings and Reforms in the President's 2007 Budget*; only an oblique reference that, "This [change] slightly increases the number of beneficiaries eligible for reduced subsidies in later years."<sup>40</sup>

### Tax Base Parameter

The income figures in Chart 2 are based on a retiree's adjusted gross income (AGI) as modified by various

tax code sections that typically do not involve retirees,<sup>41</sup> such as Code Sec. 135, which exempts interest earned on U.S. savings bonds whose proceeds are used to fund a child's college education.<sup>42</sup> But there is one adjustment that is a major issue for retirees—namely, the addition of "interest received or accrued during the taxable year which is exempt from tax under the Code."<sup>43</sup> Thus, the common practice of retirees' investing in federally tax-exempt bonds could trigger increased premiums for Medicare Part B.

**Example 3.** Dorothy has AGI of \$75,000 plus tax-exempt interest income of \$20,000. Without counting the tax-exempt interest, Dorothy would not be subject to the Medicare Part B means-testing provision, but her combined income of \$95,000 makes this provision apply to her.

Should Dorothy in Example 3 avoid tax-exempt bonds? The answer is most likely "no." That is, the fixed income alternatives that are most comparable to tax-exempt bonds are federal government bonds, corporate bonds, and bank certificates of deposit. Each alternative might provide higher nominal income than her tax-exempt bonds generate, but after Dorothy pays tax on that income, she may have less money than she does currently. Nevertheless, the higher nominal income would increase Dorothy's AGI and might thereby make her subject to a higher cost sharing percentage under Medicare Part B's means-testing provision.

**Example 4.** Dorothy in Example 3 takes the money that she previously had invested in tax-exempt bonds and buys U.S. Treasury notes instead. Assume that these securities provide Dorothy \$6,000 of additional interest income, bringing her total interest income to \$26,000. This interest income, however, is subject to Dorothy's marginal tax rate of 25 percent,<sup>44</sup> so her after-tax return on the U.S. obligations is \$19,500 (\$26,000 interest received x 75%), or \$500 less than the \$20,000 that she received tax-free in Example 3. Even so, her AGI is now \$101,000 (\$75,000 previously + \$26,000 interest income), which puts her in a higher tier of Medicare cost-sharing percentages. See Chart 2.

### Planning Implications

From a planning perspective, any transaction that increases a retiree's AGI will make that person pay

more for Medicare Part B, even if that transaction is itself treated preferentially under the tax code.

**Example 5.** Leah has AGI of \$70,000 but is considering a sale of some highly appreciated stock. Selling her stock would produce a long-term capital gain of \$140,000. Although this capital gain will be taxed at only 15 percent,<sup>45</sup> a rate that is much less than Leah's marginal tax rate on her other income, the capital gain will be included in her AGI,<sup>46</sup> so her income for the taxable year in question will be \$210,000.

**Example 6.** Edward's AGI is \$60,000 but he plans to take a lump sum distribution from his former employer's defined benefit pension fund in the amount of \$225,000. Edward is 78 years old and accordingly is eligible for 10-year forward averaging on this lump sum distribution.<sup>47</sup> Although electing this option will reduce the tax due on the lump sum distribution, the distribution itself will increase Edward's AGI from \$60,000 to \$285,000, thereby triggering a substantial increase in Edward's Medicare Part B premiums.

Similarly, a taxpayer who converts a traditional Individual Retirement Account (IRA) into a Roth IRA will increase his or her AGI and possibly that person's Medicare Part B premiums.

**Example 7.** Alice has AGI of \$65,000 and is considering converting \$125,000 of her traditional IRA into a Roth IRA. Alice is eligible to make this conversion because her AGI before the IRA conversion does not exceed \$100,000.<sup>48</sup> Nevertheless, the value of the converted IRA will increase Alice's AGI to \$190,000.

## Administrative Considerations

Medicare premiums are collected by the Social Security Administration (SSA) beginning with January of each calendar year during which a retiree is enrolled in the program. But tax returns are not due until April 15 of the next year, so the person's income for the most recently completed tax year is not known when the premiums are collected. Congress resolved this dilemma by declaring that Medicare Part B premiums will be based on an enrollee's AGI "determined for the individual's last taxable year beginning in the second calendar year preceding the year involved."<sup>49</sup>

Thus, Medicare Part B premiums for 2007 will be based on an enrollee's AGI for 2005, the tax year just filed. As a result, many retirees may not realize that transactions that they have already concluded will affect their Medicare Part B premiums next year.

Moreover, the annual adjustment nature of Medicare Part B's means-testing provision translates into fluctuating premiums from year to year. In the preceding Example 7, for instance, Alice's AGI was increased from \$65,000 to \$190,000 by the conversion of her traditional IRA. But this IRA conversion is a one-time transaction, so her AGI the following year should be significantly lower. Her Medicare Part B premiums, therefore, should decline when that later year becomes the relevant testing period.

In any case, retirees will have the option to request that the SSA use "a more recent taxable year than the taxable year otherwise used."<sup>50</sup> In other words, a retiree could ask that his AGI in 2006 be used instead of his AGI from 2005 to determine his Medicare Part B premiums in 2007. Such requests, however, will not be granted automatically. Rather, the retiree must show that the AGI for the requested year "is significantly less than such income for the taxable year determined [otherwise] ... by reason of death of such individual's spouse, the marriage or divorce of such individual, or other major life changing events specified in regulations prescribed by"<sup>51</sup> the SSA and the Treasury. Thus, it is unlikely that a one-time increase in one's AGI due to a major stock sale or an IRA conversion will qualify unless it can be tied to a "major life changing event"<sup>52</sup> as specified by the SSA. In any case, the requesting retiree will need to provide "a copy of a *filed* Federal income tax return or an equivalent document"<sup>53</sup> for the purpose of computing that person's Medicare Part B premium.

Practitioners can only imagine the difficulties that might arise when two separate federal agencies are involved. That is, the IRS is authorized to release tax return information to the SSA for this purpose.<sup>54</sup> But if increased Medicare Part B premiums result from incorrectly transmitted tax data or from erroneous SSA computations, the resulting mess might be rather difficult to sort out.<sup>55</sup> And if the base year's AGI is increased or decreased substantially due to post-filing events, such as a tax audit, it is not clear how Medicare Part B premiums will be adjusted accordingly.

## Employer Payment of Part B

Some employers pay the Medicare Part B premiums for former employees as a retiree health benefit. Un-

til 2007, this payment was the exact same amount for every former employee who was entitled to this benefit. But starting in 2007, the Medicare Part B premium might vary considerably among different former employees depending upon their individual circumstances, including their marital status, the amount of their investment income (interest, dividends, capital gains) and other factors. This situation creates a dilemma for employers and their former employees that did not exist prior to the passage of Medicare Part B means-testing.

One possibility is for the employer to pay the regular Medicare Part B premium for all former employees and let those former employees who must pay increased premiums bear that extra cost themselves. This approach would seem easy to administer and is perhaps the fairest alternative. Some retirees, however, might regard such “capping” of the former employer’s contribution to their Medicare Part B premium as a breach of whatever promises were made by the company to cover certain future health expenses.

Alternatively, an employer might agree to pay all of its former employees’ Medicare Part B premiums, regardless of what they might be. This approach raises other issues of fairness among former employees and is more difficult to administer, because the employer would need to know every retiree’s actual Medicare Part B premium. Armed with that information, an employer could do some simple computations to determine a former employee’s current tax situation, at least within certain parameters. Some retirees might be extremely uncomfortable with their former employer’s having such sensitive financial information. Comprehensive coverage of Medicare Part B premiums, however, now requires this degree of intrusiveness. In any case, the general trend toward *reducing* retiree health benefits<sup>56</sup> makes a fixed payment for all former employees the more likely scenario. As such, the impact of means-testing Medicare will probably fall on the affected retirees rather than their former employer.

### **Nonenrollment in Part B**

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Faced with this means-testing mechanism, some upper-income retirees might be tempted to forego enrolling in Medicare Part B, but they should resist that temptation. The fact is that even when means-testing is fully effective in 2009, the maximum cost-sharing percentage will be 80 percent. Accordingly, all

retirees will receive a subsidy of their Medicare Part B premium of at least 20 percent. Finding a more economical private alternative, therefore, may prove rather difficult. Moreover, private insurance alternatives typically utilize medical underwriting standards. That is, private plans set medical conditions regarding whom they will ensure, and those conditions might well exclude a particular retiree. Medicare, by contrast, accepts everyone without regard to his or her medical history, and that factor is a huge benefit that many retired people ignore at their peril.

Another strategy might be to defer enrolling in Medicare Part B rather than avoid this program altogether. Eligible persons who delay enrolling in Medicare Part B are assured of acceptance, but a delayed enrollment penalty is imposed when they do enroll in the program. That penalty is 10 percent for every 12-month period during which an eligible enrollee chose not to enroll in Medicare Part B.<sup>57</sup>

**Example 8.** Jill delays enrolling in Medicare Part B for 63 months after becoming eligible to do so. There are five 12-month periods in 63 months, so Jill’s delayed enrollment penalty is 50 percent (5 periods x 10% per period). As a result, Jill will pay 50 percent more for Medicare Part B when she does enroll in the program.

This delayed enrollment penalty, moreover, is a *permanent* addition. That is, as long as Jill in Example 8 is enrolled in Medicare Part B, she will pay 50 percent more than she otherwise would owe. And as Medicare Part B premiums increase over time, the penalty amount will rise in tandem with those increases. There is an exception to this delayed enrollment penalty provision for persons who are covered by an employer’s group health plan, but this exception applies only to those who are covered as current employees and *not* to retired former employees.<sup>58</sup> Thus, unless this employee-only exception is applicable, a retiree who defers enrolling in Medicare Part B to avoid the means-testing provision will usually find that the permanent increase in subsequent premiums from the delayed enrollment penalty will more than offset any transitory savings realized from not enrolling in the program.

### **Conclusion**

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The Medicare Act of 2003 created what is essentially a tax surcharge on upper-income retirees who participate in Medicare Part B, as almost all retirees do. Starting

at income levels of \$80,000 (\$160,000 for married couples), increased monthly premiums for Medicare Part B will be based on a retiree's adjusted gross income plus tax-exempt interest income for the second preceding year. This provision starts in 2007, based on income in 2005, and ramps up quickly over three years. Projected to reduce governmental expenses for Medicare by less than \$2 billion per year when fully implemented,<sup>59</sup> this mechanism for means-testing this

popular program will increase health care costs for some upper-income retirees by several thousands of dollars annually. As Medicare Part B premiums continue to rise over time, some affected retirees may find a private insurance plan more appealing. Choosing that alternative will usually be ill-advised, but even if few retirees abandon Medicare Part B, the new law creates fresh planning dilemmas and associated financial pain, all for relatively little governmental gain.

## ENDNOTES

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- <sup>2</sup> Code Sec. 3101(b)(6).
- <sup>3</sup> Code Sec. 3111(b)(6).
- <sup>4</sup> Code Sec. 3102(a).
- <sup>5</sup> Code Sec. 1401(b).
- <sup>6</sup> Social Security Table of Automatic Increases, [www.ssa.gov/OACT/COLA/autoAdj.html](http://www.ssa.gov/OACT/COLA/autoAdj.html).
- <sup>7</sup> See generally, LAWRENCE A. FROLIK & RICHARD L. KAPLAN, *ELDER LAW IN A NUTSHELL*, at 65–75 (3d ed. 2003).
- <sup>8</sup> *Supra* note 1, at 23.
- <sup>9</sup> 42 U.S.C. §1395x(a).
- <sup>10</sup> *Supra* note 7, at 58.
- <sup>11</sup> 42 U.S.C. §414(a)(2).
- <sup>12</sup> *Supra* note 6.
- <sup>13</sup> 42 U.S.C. §402(a)(2), (q)(1).
- <sup>14</sup> *Supra* note 7, at 59.
- <sup>15</sup> *Supra* note 7, at 60.
- <sup>16</sup> 1 U.S.C. §7.
- <sup>17</sup> *Supra* note 7, at 75–78.
- <sup>18</sup> H. RPT. NO. 108-391, at 746 (2003).
- <sup>19</sup> Center for Medicare and Medicaid Services, 2005 CMS STATISTICS, available at [www.cms.hhs.gov/MedicareMedicaidStatSupp/downloads/2005\\_CMS\\_Statistics.pdf](http://www.cms.hhs.gov/MedicareMedicaidStatSupp/downloads/2005_CMS_Statistics.pdf), at 6.
- <sup>20</sup> See Richard L. Kaplan, *Taking Medicare Seriously*, 1998 U. ILLINOIS L. REV. 777, 792.
- <sup>21</sup> Health Security Act of 1993, H.R. 3600, S. 1757, 103d Cong., §7131(a).
- <sup>22</sup> See, e.g., Guaranteed Health Insurance Act of 1994, 140 Cong. Rec. H7509 (Rep. Gephardt's bill); Health Security Act of 1994, 140 Cong. Rec. S11492 (Sen. Mitchell's bill).
- <sup>23</sup> See The Medicare Preservation Act of 1995, H.R. 2425, 104th Cong., §§15,000–15,801 (Oct. 31, 1995, version 6).
- <sup>24</sup> Balanced Budget Act of 1997, S. 947, 105th Cong., §5542 (1997).
- <sup>25</sup> Personal Responsibility and Work Opportunity Reconciliation Act (P.L. 104-193), 110 Statutes at Large 2105 (1996).
- <sup>26</sup> Jill Bernstein, *Should Higher Income Beneficiaries Pay More for Medicare?* NATIONAL ACADEMY OF SOCIAL INSURANCE, Medicare Brief #2 (1999), at 2.
- <sup>27</sup> Medicare Catastrophic Coverage Act of 1988 (P.L. 100-360), 102 Statutes at Large 683.
- <sup>28</sup> Medicare Catastrophic Coverage Repeal Act of 1989 (P.L. 101-234), 103 Statutes at Large 1979. See generally Richard Himelfarb, *CATASTROPHIC POLITICS: THE RISE AND FALL OF THE MEDICARE CATASTROPHIC COVERAGE ACT OF 1988* (1995), at 96.
- <sup>29</sup> Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (P.L. 108-173), 117 Statutes at Large 2066 (hereinafter cited as "Medicare Act").
- <sup>30</sup> Richard L. Kaplan, *The Medicare Drug Benefit: A Prescription for Confusion*, 1 NAT'L ACADEMY OF ELDER LAW ATTORNEYS J. 167 (2005).
- <sup>31</sup> See generally Richard L. Kaplan, *Who's Afraid of Personal Responsibility? Health Savings Accounts and the Future of American Health Care*, 36 McGEORGE L. REV. 535 (2005).
- <sup>32</sup> Medicare Act, §811(a), adding 42 U.S.C. §1395r(i).
- <sup>33</sup> 42 U.S.C. §1395r(i)(3)(B),(C)(i).
- <sup>34</sup> *Id.*, at §1395r(i)(3)(B), as added by Medicare Act, §811(a).
- <sup>35</sup> Deficit Reduction Act of 2005 (P.L. 109-171), 120 Statutes at Large 4.
- <sup>36</sup> *Id.*, at §5111.
- <sup>37</sup> 42 U.S.C. §1395r(i)(3)(C)(ii).
- <sup>38</sup> *Id.*, at §1395r(i)(5).
- <sup>39</sup> [www.whitehouse.gov/omb/budget/fy2007/pdf/budget/hhs.pdf](http://www.whitehouse.gov/omb/budget/fy2007/pdf/budget/hhs.pdf), at 120.
- <sup>40</sup> [www.whitehouse.gov/omb/budget/fy2007/pdf/savings.pdf](http://www.whitehouse.gov/omb/budget/fy2007/pdf/savings.pdf), at 176.
- <sup>41</sup> 42 U.S.C. §1395r(i)(4)(A)(i).
- <sup>42</sup> Code Sec. 135(a), (c)(1)(B), (c)(2)(A)(iii).
- <sup>43</sup> 42 U.S.C. §1395r(i)(4)(A)(ii).
- <sup>44</sup> Much of this additional interest income would actually be subject to a marginal tax rate of 28 percent, reducing Dorothy's after-tax return even further.
- <sup>45</sup> Code Sec. 1(h)(1)(C).
- <sup>46</sup> Code Sec. 61(a)(3).
- <sup>47</sup> *Supra* note 7, at 375–80.
- <sup>48</sup> Code Sec. 408A(c)(3)(B)(i).
- <sup>49</sup> 42 U.S.C. §1395r(i)(4)(B)(i).
- <sup>50</sup> *Id.*, at §1395r(i)(4)(C)(i)(I).
- <sup>51</sup> *Id.*, at §1395r(i)(4)(C)(ii)(II).
- <sup>52</sup> *Id.*
- <sup>53</sup> *Id.*, at §1395r(i)(4)(C)(ii)(I) (emphasis added).
- <sup>54</sup> Code Sec. 6103(l)(20)(A), added by Medicare Act, §811(c)(1).
- <sup>55</sup> See James C. Gould, *The Rebirth of an Income-Based Medicare Premium*, 101 TAX NOTES 1467, 1469 (2003).
- <sup>56</sup> See Paul Frontin, et al., *Medicare Program Takes On More Income-Related Features*, EMPLOYEE BENEFIT RESEARCH INSTITUTE NOTES (May 2004), at 1, 3.
- <sup>57</sup> 42 U.S.C. §1395r(b).
- <sup>58</sup> *Id.*
- <sup>59</sup> Mark V. Pauly, *Means-Testing in Medicare*, HEALTH AFFAIRS, Dec. 8, 2004, at 546, 547.

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