

A look at health-care reform and its impact on investors

Investor Education

Summary of legislative changes

In March 2010, the *Patient Protection and Affordable Care Act* and the *Health Care and Education Reconciliation Act* were signed into law, marking the most sweeping changes to our nation's health-care system in decades. The legislation is complex, and its consequences, both intended and unintended, remain to be seen. Two things, however, are clear today: first, that one of the core provisions of the legislation is the goal of providing health insurance to many of the more than 30 million Americans who are not presently covered by insurance, and second, that the biggest challenge to meeting that goal will be containing the skyrocketing costs of health-care coverage in the face of an already overstretched federal budget and entitlement spending programs.

Understanding the need for reform

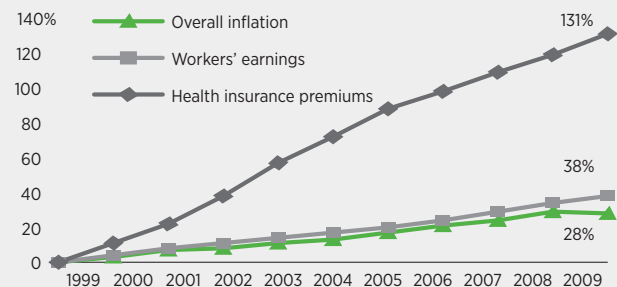
The U.S. health-care system has faced serious challenges over the past few decades fueled by rising costs, financial stress on government entitlement programs, and an aging population. Without serious reform to the health-care and entitlement systems, the financial burden to Americans is likely to only increase over time.

Health-care costs are rising rapidly

Data clearly show that U.S. citizens have long paid more per capita for health care than any other country in the world.* Why this is true is an issue of some debate, however. Many believe the United States offers the best medical services in the world, and the costs reflect that quality; others point to the fact that the U.S. has one of the highest rates of income per capita, suggesting money is being freely spent on health care by choice. Still others point to high levels

of regulation and inefficient markets to explain the rapid increase in prices. The causes of health-care cost inflation are myriad and uncertain, but one thing is indisputable: Costs have risen dramatically, with few forces working to push them down.

HEALTH-CARE COSTS ARE OUTPACING INFLATION AND EARNINGS



Source: Kaiser Family Foundation, March 2009.

Government entitlement programs are facing insolvency

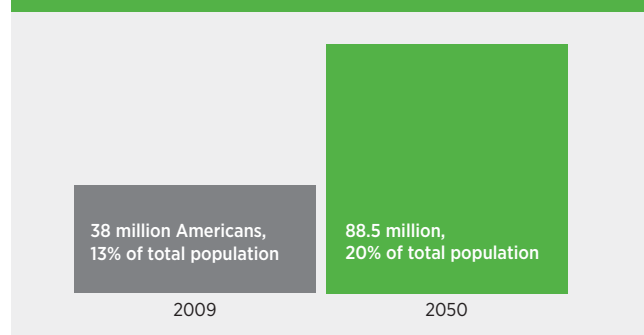
Entitlement spending in the United States is already stretched to the breaking point. This year — as a result of high unemployment leading to lower tax receipts and earlier retirements — Social Security will, for the first time, pay out more in benefits than it collects. Experts predict that in its current state, the program will be insolvent by 2037. Medicare's condition is even more dire — in 2008, the program paid out more than it took in, and the fund is expected to be fully depleted by 2017. Former Federal Reserve Board Chairman Alan Greenspan notes that the only potential fixes for the programs involve raising taxes, reducing benefits, or bailing out the programs with other government revenues — or possibly a combination of all three.

* Source: OEOD Health Data 2009.

An aging population will further strain the system

The vast majority of health-care spending occurs late in life, often in fighting the diseases that are the leading causes of death. As the baby boom generation continues to age and begins to confront late-life medical conditions, demand will almost certainly increase for costly and intensive medical treatment. Meanwhile, there is scant evidence to suggest a corresponding increase in the supply of medical staff and services; as a result, the cost of care is likely to rise.

THE NUMBER OF AMERICANS AGE 65 OR OLDER WILL DOUBLE IN THE NEXT 40 YEARS



Source: U.S. Census Bureau, Facts for Features, May 2009.

KEY PROVISIONS OF THE HEALTH-CARE LEGISLATION AFFECTING INDIVIDUALS AND SMALL BUSINESSES		
Provision	Description	Time frame
Expanded coverage	Individuals not covered by Medicaid or Medicare would be required to obtain health-care coverage or pay penalties. Certain employers not providing coverage would face penalties to help finance health-care coverage for their employees.	
Expanding coverage for dependents	Insurance policies will be required to extend dependent coverage to age 26.	2010
Tax credits for small businesses (25 or fewer employees)	Tax credits of up to 35% of premiums available to businesses that are currently offering health-care coverage for their employees as well as businesses who may now choose to start offering health-care benefits. The credit will be offered on a sliding scale: As the number of employees and average wages increase, the amount of the tax credit available will decrease. Employers must contribute at least 50% of the total premium cost to be eligible for the credit. Beginning in 2014, the maximum tax credit will increase to 50% of premiums.	2010
Promoting individual responsibility	Requires those without coverage to obtain health insurance or pay a tax penalty that will phased in and reach a maximum of \$695 per adult (\$2,085 per household) or 2.5% of taxable income by 2016. Certain lower-income families are excluded.	2014
Promoting employer responsibility	Imposes a fee on larger businesses (50 or more employees) that do not provide insurance. Fee is \$2,000 per full-time employee in excess of 30 employees.	2014
Establishment of state-operated health-care exchanges	Health insurance marketplaces available for certain uninsured individuals or small businesses (up to 100 employees) to purchase affordable health insurance through pooling different buyers.	2014
Subsidies for low-income families and expansion of Medicaid coverage	Subsidies available to assist individuals in obtaining health-care coverage based on federal poverty level (FPL). [*] Subsidies start at 133% of FPL and continue up to 400% of FPL. Expands Medicaid benefits to cover those with incomes less than 133% of FPL.	2014
Insurance reforms	Introduces new guidelines eliminating or limiting certain insurance policy provisions designed to restrict or deny coverage.	
No limitations on preexisting conditions	Insurers will no longer be able to exclude children with preexisting conditions from being covered by their family policy. For adults, a short-term, national high-risk insurance pool will be operated temporarily until state-run health insurance exchanges take effect in 2014.	2010
Restriction on lifetime and annual limits	Lifetime dollar limits on coverage eliminated, and annual limits restricted.	2010
Limitation on waiting periods	Waiting periods for coverage of greater than 90 days prohibited.	2014

^{*} 2010 Federal Poverty Level (FPL) is \$10,830 for individuals and \$22,050 for a family of four.

KEY PROVISIONS OF THE HEALTH-CARE LEGISLATION AFFECTING INDIVIDUALS AND SMALL BUSINESSES (cont.)

Provision	Description	Time frame
Tax-related provisions	A combination of new taxes and tax increases designed to offset the cost of implementing health-care reform.	
Limitations on health-care savings accounts	Ban on using funds from flexible spending accounts, health reimbursement arrangements, or health savings accounts for the cost of over-the-counter medications. FSA contributions capped at \$2,500 by 2013.	2011
Increase in the Medicare payroll tax	For higher-income taxpayers (\$200K individual, \$250K couples), the individual portion of the payroll tax increases from 1.45% to 2.35%.	2013
New Medicare surtax on investment income	Applies to higher-income households (\$200K individual, \$250K couples). Additional tax of 3.8% on net investment income such as interest, dividends, and capital gains. Income from retirement plan distributions (pensions, 401(k), IRAs, etc.) are excluded. Municipal bond interest income also excluded.	2013
Limitation on deducting medical expenses	Increases the threshold for deducting medical expenses on the federal income tax return from 7.5% of adjusted gross income (AGI) to 10% of AGI.	2013
Excise tax on medical devices	Sale of medical devices is subject to an excise tax of 2.3%. Items sold at retail to consumers are excluded.	2013
Excise tax on "Cadillac" health plans	Imposes an excise tax of 40% on group insurers if annual premiums exceed \$10,200 for individual coverage or \$27,500 for family coverage.	2018

Three ways to mitigate the impact of higher taxes due to health-care legislation

It is hard to predict exactly how the health-care legislation will affect the federal budget and, in turn, household finances. The Congressional Budget Office stated that it expects the health-care bills would help reduce the federal deficit. Meanwhile, Medicare's chief actuary, Richard Foster, predicted that "overall national health-care expenditures under the health reform act would increase by a total of \$311 billion" over the next nine years. Despite the uncertainty, based on the specific tax provisions in the new health-care bills and the mounting federal budget deficits, individuals' tax burdens are almost certain to increase over the coming months and years. The good news is that there are concrete steps investors can take to mitigate the potential impact to their finances.

Municipal bonds can provide a relatively stable source of tax-free income

The tax-free income paid by municipal bonds is one way to offset the potential for higher tax rates. Municipal bond income also is exempt from the new Medicare surtax. And because municipal bonds are often backed by the taxing power of local governments, defaults have been extremely rare, making them a relatively stable investment. Consider investing in municipal bonds with taxable assets that you do not intend to tap into over the near term.

Converting to a Roth IRA can create a source of tax-free retirement income

Distributions from retirement accounts, including Traditional and Roth IRAs are exempt from the new 3.8% Medicare surtax. Roth IRAs provide additional benefits since withdrawals are generally free from income taxes as well.

Although IRA withdrawals are not subject to the new Medicare surtax, IRA income may push a taxpayer past the threshold, exposing other investment income to the new surtax. This is the where a Roth IRA may help. Consider this example:

EXAMPLE: CONVERTING TO A ROTH IRA BEFORE 2013 COULD HELP YOU AVOID ADDITIONAL TAXES

Couple reporting wages/salary: \$150,000
 + Investment income: \$100,000
 + Traditional IRA distribution: \$50,000
 = Modified adjusted gross income (MAGI): \$300,000

Result: \$50,000 of the \$100,000 in investment income subject to 3.8% surtax (\$300K MAGI is \$50K over the \$250K threshold on which the 3.8% tax applies)

Same example but distribution of \$50,000 from Roth IRA instead of Traditional IRA

Result: Since MAGI = \$250,000 (Roth income not included), then none of the investment income is subject to the surtax

Non-dividend-paying stocks may become more attractive to investors

In 2011, if the Bush tax cuts are allowed to expire, dividends will be treated as income and, for higher-income investors, that represents an increase from the current 15% rate to a maximum of 39.6%. For individuals earning more than \$200,000 and couples earning more than \$250,000, any dividends received through equity holdings will be subject to the additional 3.8% Medicare surtax starting in 2013. All told, top income earners could see the tax rate they pay on dividends nearly triple, increasing from 15% to 43.4%. As a result, higher-income earners may favor the stocks of companies that reinvest capital to fuel growth over those that use capital to pay dividends.

The health-care industry will face new challenges and create new opportunities

There is certainly concern that pricing concessions, coverage mandates, and increased regulation may negatively impact the health-care industry. However, regardless of how Americans finance health-care services in the future — whether through new government programs or personal savings accounts — demand today is high, and only likely to increase over time. Aging baby boomers, longer life expectancies, and increases to the ranks of insured individuals likely will combine to ensure a constant need for cutting-edge medicines and procedures. If history is any guide, the health-care industry will continue to innovate to meet these demands and may very well create compelling investment opportunities along the way. Health-care stocks or actively managed health-care funds are one way to tap into the growth potential the industry offers.

Talk to your financial advisor or tax professional today

Significant changes to tax laws will be phased in over the next few years, and investors would be well served to keep a close eye on how these changes will impact their personal finances. The best preparation you can make is to consult with a financial advisor or tax professional, who can offer some perspective on your specific financial and tax situation, help you understand the risks, and position your assets accordingly. The markets and the regulatory environments are always changing, and in uncertain times like these, sound financial advice should be the foundation of any long-term investment strategy.

This information is not meant as tax or legal advice. Please consult with the appropriate tax or legal professional regarding your particular circumstances before making any investment decisions.

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