Looking forward into 2014, four dates – February 7, March 31, April 15 and November 4 – stand out as pivot points for events that could affect the markets, particular industries, and tax and financial planning.

**February 7 – The United States loses authority to borrow**

Last October, Congress reached a compromise to reopen the federal government. The compromise set up a bipartisan committee to develop an appropriations plan for future government operations. The leaders of that committee subsequently announced a plan to fund the government through September 30, 2015. Although this compromise allows the government to expend funds through September 2015, the government is authorized to borrow money to meet those expenses only through February 7, 2014. (This disconnect occurs because budgeting for government spending and authorizing government borrowing often proceed on different legislative tracks.) After February 7, the government will be required to sustain itself without borrowing, which it will do for a few months using tax receipts and other funds. But at some point this spring the need to borrow will become acute. At that point, Congress will have to act to raise the nation's borrowing limit. If Congress fails to do so, then the United States, unable to borrow to pay interest, will default on the national debt.

Twice in recent years – in August 2011 and October 2013 – negotiations to raise the debt limit came down to the wire before Congress reached agreement to avoid a default. The same phenomenon could occur this spring. The partisan rhetoric already has begun. In December, Representative Paul Ryan, the Republican chair of the House Budget Committee, said, “We don’t want nothing [i.e., The Republicans want something] out of this debt limit. We are going to decide what it is we can accomplish out of this fight.”

Specifically, the Republicans would like to “accomplish” meaningful changes to the major entitlement programs, Social Security and Medicare, in order to reduce future spending and put the government's finances on a more sustainable fiscal path. Those changes include reducing the cost-of-living index by which increases in Social Security benefits are measured, and requiring affluent recipients to pay more for Medicare coverage.

President Obama has said that he does not intend to negotiate over raising the debt ceiling, asserting that it is Congress' responsibility to ensure the government is able to pay the expenses that Congress has authorized. In other contexts, the President has said that he would agree to changes in entitlement spending only if Republicans agree to new taxes on affluent families. In that regard, he has proposed (and in February is likely to re-propose) a number of controversial tax changes, including taxing municipal...
bond interest, limiting the amount individuals may accumulate in tax-preferred retirement accounts, and reversing recent expansions of the estate and gift tax exemptions. None of these proposals are acceptable to Republicans.

The last two times the United States has approached a debt limit deadline I have said that Congress will not permit the country to default on the national debt. I continue to believe that is the case. But negotiations toward an agreement can be harrowing, and the apparent lack of progress in the weeks leading up to the default date can rattle the markets. Prior to the debt ceiling negotiations in August 2011 and October 2013, I stated that the markets, concerned about Congressional inaction, would suffer a temporary downturn as the deadline approached. Because I knew Congress would not allow the nation to default, I suggested that investors should view these downturns as a buying opportunity because I believed the markets would rebound once an agreement was in sight. This is exactly what transpired.

Source: Congress Returns from Recess to Face Fiscal Deadlines. September 2013.

Investors should look for similar buying opportunities this spring if Congress’ partisan bickering rattles the markets and leads to a downturn. Because I do not believe Congress will allow the U.S. to default, the markets should come back once an agreement is reached.

**March 31 – The Affordable Care Act individual mandate penalties apply**

Contrary to the understanding of many Americans, the Affordable Care Act (ACA) – more popularly known as “Obamacare” – does not institute a new, government-run health plan. Instead, the health care reform law seeks to ensure that virtually every American has health insurance.

To accomplish that goal, the law institutes a controversial trade-off. On one hand, the law imposes an “individual mandate” that requires all Americans to have health insurance coverage beginning January 1, 2014. On the other hand, it requires insurance companies to accept all applications for insurance and charge equally for coverage regardless of an applicant’s sickness or prior poor health. (The only allowable differences in premiums are those based on age and tobacco use.) Insurance companies acceded to this restriction because the individual mandate was to ensure that healthy people also have insurance, preventing the coverage pool from being skewed toward people more likely to need costly medical treatment.

Thus, under the individual mandate, people who do not receive health insurance through an employer or under Medicare or Medicaid are required to purchase coverage or to pay a penalty for failing to do so. To ease the burden on lower- and middle-income families, the law provides for premium subsidies. To defray the cost of these subsidies, the law (i) imposes a new 3.8% tax on investment income earned by higher income taxpayers beginning in 2013, and (ii) reduces amounts paid to doctors, drug companies, and hospitals for services and products they provide to patients covered by Medicare and Medicaid. Hospitals agreed to these lower reimbursements because all patients using emergency room services would now have insurance, ensuring that the hospital would receive payment for services provided. Similarly, drug companies agreed to the cut because they believed that newly covered individuals would provide a new market for the sale of their drugs.

The implementation of Obamacare at the end of 2013, however, has raised concerns about whether the individual mandate, in fact, will result in near-universal insurance coverage. These concerns arise from the following factors:

- Under the law as written, families with income under approximately $24,000 were to receive insurance at no cost under Medicaid. This provision of free insurance represented a significant expansion of existing Medicaid coverage, and the law required the states to pay a portion of the Medicaid expansion cost. The Supreme Court, however, held that the federal
government cannot constitutionally require the states to contribute to this expansion of Medicaid. Instead, each state has a choice whether to expand Medicaid for its residents. Many states (typically those with Democratic governors) have decided to expand Medicaid and provide the additional free insurance (and bear a portion of the cost of doing so). But many other states (typically those with Republican governors) have chosen not to expand Medicaid. Low-income families living in states that do not expand Medicaid will have health insurance only if they access it through an employer or purchase it on an exchange. Thus, very few low-income families living in states that do not expand Medicaid are likely to have insurance coverage.

• Young and healthy workers might choose to pay the penalty rather than purchase insurance. When fully phased in, the maximum penalty for failing to comply with the individual mandate is $2085 per family or 2.5% of taxable income, whichever is greater. The well-publicized problems with the federal Obamacare website exacerbate these concerns because young, healthy people are less willing to incur the greater inconvenience of signing up.

• In many cases the penalty will be difficult to collect. The IRS, which is charged with collecting the penalty, is permitted to do so only by reducing a tax refund otherwise due. Thus, the penalty cannot be collected from people who are never owed a tax refund, either because they underwithhold, underpay their estimated taxes or do not pay federal income tax at all. People not owed tax refunds might be less likely to purchase insurance unless they need it due to past sickness.

To avoid the individual mandate penalty, an uninsured individual must purchase insurance by March 31, 2014. Shortly after that date, we should know the extent to which young, healthy people, in fact, purchased coverage. The early returns are not encouraging: Health insurer Humana has already announced that its enrollment mix in private plans sold through the federal website will be “more adverse than previously expected.”

Source: Reuters, January 10, 2014.

If this trend continues, doctors, drug companies and hospitals will face a double whammy: They will be receiving lower Medicare and Medicaid reimbursements without the assurance that all their customers will have insurance enabling them to pay for services and products. This consequence could adversely affect the value of investments in the health care sector. Longer term, health insurers – faced with covering a costly insurance pool skewed toward people who have exhibited health problems – also could feel a squeeze on profits.

Individuals who do not currently have health insurance through their employer or under Medicare or Medicare must decide by March 31 whether to purchase coverage or instead to incur the penalty. Those deciding to incur the penalty might want to adjust their tax withholding or estimated payments to avoid receiving a refund in the current or future years from which the IRS can collect the penalty.

April 15 – Federal tax payments are due

The fiscal cliff compromise reached by Congress at year-end 2012, combined with the new Obamacare surtax on investment income, resulted in a significant increase in tax rates in 2013. For many investors, this rate increase can be as much as ten percentage points.

Taxpayers have already felt the effects of the tax increase on compensation and business income through higher employer withholding or estimated tax payments during 2013. But few taxpayers prepay taxes on their investment income. Instead, they will feel the effects of the higher tax rates on investment income on April 15, when they file their return or request an extension. Combine these higher tax rates with the greater investment income they earned in 2013 due to strong market performance, and many taxpayers will be facing severe sticker shock in a few months.
Investors and their financial advisors should regard these higher taxes as a wake-up call for better tax planning going forward. Ideas for reducing taxes on investment income include:

- Give increased attention to harvesting losses and to buy-and-hold investment strategies.
- Consider tax-efficient mutual funds and other professionally managed tax-advantaged investment strategies.
- Consider tax-exempt municipal bonds and master limited partnerships that seek tax-shielded returns.
- Take advantage of sophisticated wealth transfer techniques.
- Move tax-inefficient investments to tax-deferral vehicles, such as IRAs, variable life insurance and variable annuities.

**November 4 – The midyear elections take place**

On Election Day this year Americans will vote on all 435 members of the House of Representatives and more than a third of the 100 members of the Senate. The election is likely to be a spirited affair, with each party vying to hold onto one house of Congress and to win the other. The outcome of the elections will affect Washington policymaking during the tail end of 2014 and the final two years of the Obama presidency. A later white paper will provide my views for the composition of Congress after the election and what that will mean for tax and fiscal legislation going forward.

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**Important Information and Disclosure**

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