Episode 42: Tax Planning for Early Retirees and the Affordable Care Act

Bob French 00:00
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Alex Murguia 00:48
Hey everybody, Alex here. Welcome to Retire with Style. And I'm here with Wade. And this we're coming off of Thanksgiving break. So I hope everyone here had a great Thanksgiving. How was your Thanksgiving? Wade?

Wade Pfau 01:07
Oh, yeah, pretty good. And the family together that immediate family? Better? Yeah. Had Turkey and all the fixings so can't really complain. That's what it's all about. Yeah. You had a big gathering, right?

Alex Murguia 01:22
Yeah. Yeah. It's fairly large. Yeah, just like you all the fixings. More than you can eat. So, to that extent, you know, I'm very blessed my family myself, and yeah, can't complain. I mean, great time to get together. So yeah, awesome.

Wade Pfau 01:42
Absolutely. Coming out for Thanksgiving, we've got a topic today that we sometimes we say, Oh, this is gonna be a short episode. We'll see how that goes. But it is what

Alex Murguia 01:52
We know people wishing we do know people wish we could do that. Short episodes. But then so what do we what are we talking about today? Which one?

Wade Pfau 02:04
Well, in the theme. So last week, we had Michael Fink on to talk about one of his recent articles and advisor perspectives. So I thought, well, let's continue that theme. And I'll talk about my most recent article from advisor perspectives, which is was published just in mid November, on looking at the tax planning implications of the health insurance subsidies for individuals who get health insurance through the Affordable Care Act.

Alex Murguia 02:30
Nice. So Wade

Wade Pfau 02:31
Which is not a majority of Americans. And it's also it's for individuals who are pre Medicare still. So this is, if there's one episode that maybe doesn't apply to the entire audience, this might be the one. But if you are someone who does maybe an early retiree, before age 65, using the Affordable Care Act for health insurance, this can be quite a relevant, important episode for you.

Alex Murguia 02:57
So why did you decide to talk about this specifically, because Michael just did his last week, and you're like, you know what, I gotta throw one of mine in there.

Wade Pfau 03:06
Just to make sure I get one agenesis. Now, we did originally have a guest plan that we'll have in the future, but some family illnesses came up that we're at the last minute looking for a new topic that we can quickly put together. So that's the genesis this week's

Alex Murguia 03:24
okay, it wasn't one upmanship. I'm thinking

Wade Pfau 03:27
a little inside baseball there.

Alex Murguia 03:30
Man far away. This is a good article are you know, we obviously went through it? Do you want to begin it?

Wade Pfau 03:37
Well, yeah, I mean, I mean, just the general point later, at some point, we will have an entire series of episodes about tax planning for retirement. There's a lot of coverage out there of some of those important issues like the the Social Security tax torpedo, the Medicare surcharges, which we'll talk about can be a double whammy for two years with people who are using the Affordable Care Act. But other things like that, you don't see as much attention paid to the loss of health insurance subsidies. And so I thought there's a little niche there, it's worth writing a column that just explains how that works. And there's a different set of rules that's now in place to 2025. And if no update is made, although really they should just make the current rules permanent, to some extent, but in 2026, there'll be a different set of rules, if no action is taken. And in Yeah, it's if you're getting your health insurance through a health exchanges, state health exchange, or just the more general health that what is the WebShell website health insurance.gov, I believe, or something along those lines. I'm looking for the exact link there and I'm not seeing it, but if you're getting your ID fordable care act more broadly. healthcare.gov Yeah, that's it. Thank you healthcare.gov each dollar of income that you have for this The Affordable Care Act modified adjusted gross income can lead to a loss of subsidy anywhere from the ranges from 6% to 18.5%. So it's a marginal tax, like taxes, you can say when you have to pay more taxes. But a

loss of a subsidy is just sort of like a negative version of that you're, you're effectively paying more taxes, you're paying a higher premium on your health insurance, as you generate more taxable income. So it is something to keep in mind, if you are thinking about Roth conversions and so forth, that there's an additional clinical penalty from generating additional taxable income beyond the tax brackets.

Alex Murguia 05:42
And just to be clear, this is this is a for people that are using health care coverage through the Affordable Care Act, is that correct?

Wade Pfau 05:50
And in 2022, there's 14 point 5 million Americans who we're talking about today, effectively. So the US population I do thinks around 300 million. So it's not everyone, but uh, if it is you it's an important issue.

Alex Murguia 06:08
Yeah, and you want to take us through one of these examples?

Wade Pfau 06:11
Well, sure, yeah. I mean, the so the idea is really just explaining how this works. And also, if you just look online about the Affordable Care Act, the examples are usually for 45, or 40 year olds, showing lower health insurance premiums, but they are age based. And so in 2023, the expected national average health insurance premium over a year like annual for a 60 year old non smoking couple is $23,450. So it's a pretty big premium. I'm sorry, $23,250. And so the idea is, if your incomes low enough, you'll receive a subsidy for the entire amount, I guess we should back up a little bit too, and just explain where these premium subsidy numbers come from? Well, yeah, so if you've ever plans, there's Bronze plans or silver plans, there's gold plans, and there's platinum plans. And as you move in the direction from bronze to platinum, usually the premiums increase, but then the out of pocket expenses decrease, it's, you're paying more out of pocket with a Bronze plan, but you'd have a lower premium generally, and with platinum, higher premium, but less out of pocket costs. So the idea of the subsidies is that an American should be able to afford a Silver plan. But specifically, the second to least expensive silver plan in their county, this is done county level across the United States. So when I said a nationally average premium, that's across all the counties in the US, within a given county, these numbers can vary quite a bit. But there could be, you know, 20, 30, 40 different Silver plans, you can just manually look up in your county, what is the second to least expensive premium, and then the subsidy would be based on that. Or you could look at a more general website that is aggregating that kind of information for you. So county by county, what's the second second least expensive silver plan. And then what the subsidy is based on is what you're expected to pay as a percentage of your income. And it's specifically your ACA, modified adjusted gross income, which is your general income sources, the your adjusted gross income. And then they're going to add in a few other factors, tax exempt interest, which shows up a lot and all this Social Security tax torpedoes, Irma surcharges from Medicare and so forth, that would be talking about more in other episodes, but also the Affordable Care Act. And then another one is your entire social security benefit shows up in the Affordable Care Act modified adjusted gross income. So you may only have a portion of that being taxable for federal purposes, but it's entirely counted. And so we talk a lot about delaying Social Security, especially if you're receiving subsidies for your health insurance through the Affordable Care Act plan. That can be a very strong

incentive to delay social security because any social security benefit you're receiving can can have a big impact on reducing the amount of subsidy or effectively increasing the taxes you pay for that coverage. Okay, so that's the basic idea. Now the percentage of the income you can pay does get kind of complicated, and I'm guess, probably just hearing about it the first time you might want to actually just read that part of the article. We can discuss it briefly but if you do want the full story of that, we'll put the link in the show notes for you. In today's episode, but it's, you know how to best think about that. There's, we've looked at the poverty threshold, it's based on poverty rates. So in the 48, Continental US states, there's one set of poverty rates. Alaska and Hawaii have different rates. But you look at for what's the household size, there, the poverty threshold depends on household size. And then also, really, you're going to use that. And there's these different thresholds based on that 150% of the federal poverty threshold for your household based on your household size 300% 400%. So in the example I use in the article, the federal poverty threshold, we're talking about the kind of the case study, it's a six year old couple, and it is a two person household, so they don't have other family members in the household that would increase their poverty threshold, the poverty threshold and in 2020, for coverage in 2023, you use the 2022 numbers. $18,310 is the federal poverty threshold for a two person household in the US in the continental United States. So 150% of that. Now, at some point, you'll just qualify for Medicare depends on which state if your income is below either 100, or, more commonly, with expanded Medicaid 130% of the federal poverty threshold, you're covered through Medicaid, then you get 100 and 100% of the subsidy up until you're at 150%, of the federal poverty line. And then, and that would be in this example, $27,465, then you're gonna have an increasing percentage of your income, you're expected to pay going from zero to 6%, until you get up to 300% of the federal poverty line, which would be $54,930. And then between 6% and 8.5% of your income, until you get up to 400% of the federal poverty line. And that is $73,240, in this example, and then once you're above that, you're expected to pay eight and a half percent. Now with our example, you can see the $23,250 annual premium. That being a, you divide that by eight and a half percent, you're getting up over $200,000, it's more even more than $270,000 of income where you're still eligible for subsidy. And so that that's how the portion of your income you're expected to pay is determined. And then the subsidy you receive is just the difference between the cost of the insurance for that, again, for that second least expensive silver plan and the portion of your income you're expected to pay. So I hope you got all that Alex Did that make sense? Whenever we describe these kinds of government rules, it's they don't make things easy, and that the marginal tax rates coming out of this are not easy, either.

Alex Murguia 13:12
I'm realizing I realized this is a podcast, you probably like it's important issue. That's why we were bringing it up. And like it's one of these that it's just the facts kind of podcast today. But you're going to print out the article and use it with you because it is you know, 10% or 5% of 6% or 7% kind of gets difficult to to maintain and, you know, aids with the one and only, you know, that's fine. He's the scarce resource, he can kind of make sense of these, you know, very complicated workflows.

Wade Pfau 13:50
Yeah, this is it's complicated enough that you probably do want to read this article, if it does apply to you. On the podcast, it's,

Alex Murguia 14:01

but I think it's important that people kind of recognize because you're, you know, you're correct, who would this apply for? Who would this apply to? You know, if someone's listening to this episode, you know, what should they be thinking? Because they're listening to you and it What's it, what's the quick way they can recognize, okay, does this does this particular information apply to me? I will say this, it applies to somebody that you know, so I, you know, I look forward to the long term, because you're not gonna see many podcasts take time to really, you know, break this down, but you're talking about a significant amount of, of dollars at play, and healthcare related,

Wade Pfau 14:36
right, and it applies to high incomes as well, because the premiums do get more expensive with age that when we're talking about people in their 50s or 60s, what they like and like I said, in this case study, it's 200. You could have your ACA modified adjusted gross income at $270,000 and still be receiving subsidy. So it's not just Something for like, lower income individuals and so forth, it applies to a wide range of the population who is receiving insurance through this program.

Bob French 15:13
Let's take a moment to let the audience know that this show is sponsored by retirement researcher. You can learn more about retirement researcher at retirement researcher.com And subscribe to our newsletter, where You'll receive weekly actionable information for your retirement planning benefit. Retirement researcher is an online community devoted to helping you create the retirement income plan geared towards your goals.

Wade Pfau 15:39
And that being said, so the chart I mean, it's it's a complicated system. But what it leads to, and this is where, whenever the government makes these kinds of rules, they make it really complicated. And it's probably not worth trying to describe the entire shape of this curve. But we have this kind of Batman tax, I call it because when you plot out the marginal tax rates implied from this, it looks like Batman is appearing in it, it's once you hit that 150% of the federal poverty line, you start at a 6% marginal tax rate, which just means if I have another dollar of income, I'll lose six cents of the subsidy. And then that starts increasing, and it gets up to 18%. At that 300%, federal poverty threshold. And then once you switch to a different, like less aggressive subsidy reduction range, that drops down a little bit below 14%, but then works its way back up to 18 and a half percent. When you get to that 400% of the federal poverty line. Now, the old rule that could return in 2026 is there's no subsidy beyond 400%. And that's a huge kind of deal, because you could lose a lot by just having $1 have too much income. That rule is not currently in place that's between 2021 and 2025. We are using a different rule where the subsidies continue at eight and a half percent beyond that. And then just keep going up depending on how high the health insurance plan is. So how much premium would you get? How long does that subsidy last? Again, it for these age ranges? It can be hundreds of 1000s of dollars I ran for Greenwich, Connecticut, it was you can have over $400,000 of income and still be receiving subsidy.

Alex Murguia 17:32
Did you do one for Little Havana in Miami.

Wade Pfau 17:36

It's just trying to I don't know which county has the most expensive health insurance. But I thought Greenwich sounded pretty posh. So I tried to

Alex Murguia 17:45
do you suspect when you get these rules where you know, they kind of Sunset them off. And you know it a third year, it kind of goes back to, you know, some some level that, you know, at first glance seems unreasonable? What's your expectation of what will happen after a few years, you think they'll they'll continue to kick this down the road? Or will they just let it let it dry out? Let the subsidies drop.

Wade Pfau 18:10
I think they really have to continue it because it's just well, the old system is insane. And like I said, if you have $1 Too much income, you could lose, depending on the cost of your insurance 10 $20,000 of subsidy, it's an insane marginal tax rate there. And that was when the Affordable Care Act first came into place that that 400% of the poverty line that's called a subsidy cliff. And they did it they made they made more generous subsidies starting in 2021. And then they renewed that again, in this this year with the part of the inflation reduction act through 2025. So I would expect that to continue. But under current law, it will not continue. We'll go back to $1 above 400%. And you get nothing. So we just do have to see how that plays out in a few years. Okay. Now, the planning implications of that, like I didn't mention, we usually talk about delaying Social Security. And if you're 62 years old and getting health insurance through the Affordable Care Act, this is like a very strong incentive to also delay Social Security unless your income is so high that you're getting above these high thresholds. We're talking about like 200 $300,000 range.

Alex Murguia 19:38
And just to be clear, you're saying delay Social Security. So your income level doesn't state doesn't take you over the subsidy. So you want to kind of reduce it and reduce it. You don't want to claim just yet so you don't accept the income,

Wade Pfau 19:51
right? Because not only do you get the benefit of having that higher social security benefit later, but if you if you took the benefit at 62, it will result in you receiving less subsidy. So it's not, you're not giving really your full age 62 benefit, you're getting your age 62 benefit, less less all the subsidies you lost, because 100% of that benefit goes into the calculation of what your subsidy will be. Which can be a pretty big impact here, especially if your income is in that like, if you're in the 30,000 40,000 50,000 $60,000 range. It's where you're talking about these up to 18 and a half percent marginal tax rates. So it can be a big impact on your subsidy reduction. It's just a further reason to delay Social Security. There's one other thing we might want to mention as well, which is, when your age is 63 and 64, you get a double whammy. Because this is assuming again, your your insurance is coming through the Affordable Care Act. Because you have to deal with your current your income is impacting your subsidy. But then also starting at age 63. Your income your modified adjusted gross income for Medicare is going to impact two years later, the Medicare premium you'll pay when you become eligible for Medicare at 65. So it's like my age 63 income is reducing my subsidy for health insurance at age 63. And it's leading me to have to pay more premiums for Medicare at age 65. If I do exceed those Medicare thresholds, which will have a whole nother episode in the future about that aspect, we won't

get into all the details right now. But it is interesting point that you can get this double whammy of having your income this year impact how much you're paying for health insurance in two different years.

Bob French 21:48
Are you getting close to or are you in retirement? Well, investing during retirement is a little bit different than during your working years. Your investments are there to help you pay for retirement. And now is when they need to earn their keep to make sure you're on the right track, download retirement researchers eight tips to becoming a retirement income investor by heading over to retirement researcher.com/eight tips, again, get retirement researchers eight tips becoming a retirement income investor by going to retirementresearcher.com/eight tips. That's the number eight tips.

Alex Murguia 22:26
So there really is this sort of chess game that you play when you when you get to be about 60. Right? I mean, we're not talking about the social security, claiming strategies, potential Roth conversions, etc, etc. This is kind of another thing that you really have to pay attention to, you know, obviously, if you qualify for these types of plans, which, as you said 15 million do and, you know, you're still talking since it's since it's county specific that back into what that number is. And so, like you said, you could be a Stanford, Connecticut, and you may still qualify even at a five $400,000 a year salary. So it's not something that, you know, should be just ignored.

Wade Pfau 23:08
Right, right, it gets into this whole tax planning topic. And generally, the idea is, if you're an early retiree, it may be a good opportunity to do Roth conversions, which generates a higher adjusted gross income. And then you just do want to be aware of that. The downside of that is if you're getting your health insurance as an early retiree through the Affordable Care Act, there's a higher marginal tax. It's not just federal income tax brackets, but also loss of subsidies for your health insurance. And why not might not necessarily overturn the decision, but at least would potentially weigh against to being as aggressive about Roth conversions.

Alex Murguia 23:47
And Wade just a minute, just to ask the question to ask the question, why wouldn't you want to get insurance in the Affordable Care Act?

Wade Pfau 23:56
Why wouldn't you want or what

Alex Murguia 23:57
what other options would you have that you could get?

Wade Pfau 24:00
Oh, other? Oh, yeah. I mean, there's, if you're an early retiree, well, you could, if you're lucky, you might be able to get retiree health insurance to your previous employer, then it's not an issue for you, Cobra, but that can be quite expensive, but and also limited duration of time. Could be another way. You're not

going to get any subsidies for that. But it could be an alternative as well. There's other I know, health care plans are becoming more popular. Those are it's not technically health insurance, but it works in a very similar manner, often through different like religious type organizations.

Alex Murguia 24:40
Actually, that comes up a lot

Wade Pfau 24:44
Health insurance through a spouse. If one spouse is still working, would probably be the best option in most cases. But yeah, there are other options. It's just before the Affordable Care Act One potential downside of an early Retirement is you don't have a good source for health insurance, or at least the health insurance can be quite expensive. And the Affordable Care Act with the subsidies that created did facilitate making it easier for an early retiree to get affordable health insurance.

Alex Murguia 25:16
No and this gives people everything I brought it up to gives people an option, a lot of folks retire at 65, specifically, because that's when their Medicare decision is made. Right. And so they try to stick around for at least that long. But there's two caveats there, you know, if you're in a situation that you absolutely dread, they're off options, right? And then you may not have a spouse insurance or, you know, Cobra may be cost prohibitive, or whatnot. The other piece is, as we've mentioned, we've mentioned previously in these podcasts, and read mentioned as a retirement risk, folks retire unexpectedly early, you know, a lot of folks think, Okay, I'm gonna retire at 65. But there are various reasons why people actually retire sooner than that age that are out of their control. And so this ever does happen, you know, it's good for you to know what options you have available to yourself.

Wade Pfau 26:14
You Yeah, and how that can impact the the tax planning that you might want to do. And that's really the the story. So I think we can go ahead, and we don't have one of our epically long episodes this weekend. But I think this is again, it's an issue that doesn't apply to everyone. But if it does apply to you, it's a really important issue. So

Alex Murguia 26:35
We figured though, there was there was a lot of math to do in this one. So if you listened to it twice, it's probably the length of one of normal you know, there you have it. And this is one of these getting Get out Get the information kind of episode, so more than happy to oblige.

Wade Pfau 26:57
So thanks, everyone, and we'll see you again next week, probably with a special guest.

Alex Murguia 27:02
Yeah. Alrighty everyone. Hope you enjoy the holidays. Take care.

Bob French 27:08

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