Tax Considerations for Relatively Wealthy Households

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Many households follow the following pattern. In their preretirement years, they make yearly contributions to tax-deferred accounts (TDA) like a 401(k). In retirement, they delay TDA withdrawals until RMDs begin and they limit these withdrawals to their RMDs. Once they begin Medicare, late in each calendar year, the government tells them what their monthly Medicare premium levels will be the next calendar year. In this column, I concentrate on relatively wealthy households, which I define as those that should be concerned with how one more yearly contribution to a TDA could affect the levels of their future Medicare premiums. I warn these relatively wealthy households that the government could tax away almost all of this last yearly contribution to a TDA. Thus, I encourage these households to consider saving in Roth accounts instead of TDAs and making Roth conversions in their preretirement years, especially before 2026 when higher tax rates are scheduled to return.

The Decision to Save in a TDA or a Roth Account

Consider a single individual or married couple that is deciding whether to save this preretirement year in a TDA or a Roth account. Assume they are in the 24 percent tax bracket in this preretirement year, which is also their marginal tax rate (MTR), where MTR denotes the additional taxes paid on the next dollar of ordinary income. If they save the equivalent of $1 of pretax funds in the Roth account, its after-tax value this year will be $0.76. If they save in a TDA, then their initial balance will be $1 of pretax funds. Assume that the funds are invested in the same portfolio of assets that earns a geometric average annual return of r percent for n years, at which time the funds are withdrawn and spent. In this case, the after-tax value of the Roth account at withdrawal n years hence will be $\$0.76(1 + r)^n$. If the savings are contributed to the TDA, then its pretax value n years hence will be $\$1(1 + r)^n$, while its after-tax value will be $\$1(1 + r)^n (1 - t_n)$, where t_n denotes the MTR in the withdrawal year.

A comparison of these two after-tax values—$\$0.76(1 + r)^n$ and $\$1(1 + r)^n (1 - t_n)$—indicates that the household should save in a TDA if their MTR in retirement is expected to be less than

their MTR this year (i.e., if t_n < 24 percent), while they should save in the Roth account if their MTR in retirement is expected to be higher than their MTR this year (i.e., if t_n > 24 percent). The key comparison is the size of the MTRs in the contribution and withdrawal years. As explained in Reichenstein (2021), multiple financial professionals mistakenly assume the comparison should be between the tax brackets in the contribution and retirement years. The MTR in the contribution year, which is a preretirement year, is usually the tax bracket. However, as explained in Reichenstein and Meyer (2018 and 2020) and Reichenstein (2019 and 2021), the MTR in the withdrawal year, which is usually a retirement year, is frequently much higher than that year's tax bracket. In this column, I show that one more yearly contribution to a TDA by a relatively wealthy household could cause it to have to pay higher Medicare premiums for several years.

The same analytic framework applies to the decision to convert TDA funds to a Roth account this year. The Roth conversion only makes sense if this year's MTR is less than the expected MTR in retirement. However, since the MTR for many people during their retirement years will be higher than their tax brackets, a Roth conversion this year makes sense for many people.

Income-based Medicare Premiums for Relatively Wealthy Households

This article is about households whose income places them beyond the end of the tax torpedo, which is where they pay taxes on 85 percent of their Social Security benefits, which is the maximum. I will call these "relatively wealthy households." These households should be concerned with how their saving decisions will impact the levels of their Medicare premiums in their retirement years.

The Affordable Care Act instituted higher Medicare premiums for retirees as their income level increases. Since the level of Medicare premiums increase as a household's income increases, these increases are effectively tax increases. The term denoting the portion of premiums that increases with income is called the Income-Related Monthly Adjustment Amount (IRMAA). In general, Medicare premiums for one year are based on Modified Adjusted Gross Income levels from two years earlier. MAGI is defined as AGI plus tax-exempt interest.

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Table 1 shows how monthly 2021 Medicare premium levels increase when MAGI levels in 2019 breach income threshold levels. The 2021 income threshold levels for MAGI are \$88,000, \$111,000, \$138,000, \$165,000, and \$500,000 for singles, heads of households, and qualifying widow(er)s with a dependent child (henceforth, singles). Except for the last income threshold level, these threshold levels are twice as high for married couples filing jointly (henceforth, married couples).

I explain how the 2019 MAGI level affects monthly Medicare premiums in 2021 for a married couple. For MAGI of \$176,000 or lower, the standard premium for Part B applies to both spouses, which in 2021 is \$148.50 per month and, when applicable, the plan premium for Part D (drugs) applies. If the last dollar of income in 2019 causes MAGI to exceed \$176,000 and both spouses are covered by Parts B and D for all 12 months of 2021,

Table 1: 2021 Monthly Medicare IRMMA Premium Levels as MAGI Increases

Singles	Couples	Part B	Part D	Additional Annual Premiums (IRMAAs)
≤ $88K	≤ $176K	Standard Premium (SP)	Plan Premium (PP)	Couples taking Parts B and D for all 12 months
$88K to $111K	$176K to $222K	SP + $59.40	PP + $12.30	$1,720.80
$111K to $138K	$222K to $276K	SP + $148.50	PP + $31.80	$4,327.20 (+$2,606.40)
$138K to $165K	$276K to $330K	SP + $237.60	PP + $51.20	$6,931.20 (+$2,604)
$165K to $500K	$330K to $750K	SP + $326.70	PP + $70.70	$9,537.60 (+$2,606.40)
≥ $500K	≥ $750K	SP + $356.40	PP + $77.10	$10,404 (+$866.40)

then their joint annual premiums rise by $1,720.80: [($59.40 + $12.30) × 12 months × 2 spouses]. Thus, this dollar of 2019 income causes them to pay more than $1,720 more to the federal government. This represents an MTR exceeding 172,000 percent. Similarly, if their last dollar of 2019 income causes their MAGI to exceed the second, third, or fourth MAGI threshold level, then their joint 2021 annual Part B and D premiums will increase by more than $2,600, which represents an MTR exceeding 260,000 percent. Similarly, for a single individual who is on Medicare Parts B and D for all 12 months of 2021, if her last dollar of 2019 income causes her MAGI to exceed the second, third, or fourth MAGI threshold level, then her 2021 annual Medicare premiums will increase by more than $1,300, which represent an MTR exceeding 130,000 percent.

How One More Contribution to a TDA Could Affect Lifetime Medicare Premiums

The purpose of the example in this section is to illustrate a problem for relatively wealthy households that are considering whether to save in a TDA or a Roth account. This example shows that if a relatively wealthy single individual saves one more year in a TDA, it could cause her to have to pay one more IRMAA for several additional years. Although I use a single household in this example, the same problem exists for married couples filing jointly. In fact, the additional IRMAA for a married couple could be twice as high.

Assume Amanda, our single client, turned 72 in 2019. She will be on Medicare Parts B and D in 2021. Like most retirees, she will limit her TDA withdrawal each year to her RMD.[1] For simplicity and for clarity, in Table 2 I assume all of the following increase by the inflation rate each year: Social Security benefits, MAGI threshold levels, IRMAAs, tax brackets, standard deduction, etc. Thus, these dollar amounts are expressed in real terms.

Amanda's ending TDA balance at the end of the year she turned 71—that is, the year before she started RMDs—is $2,230,908.27. She will receive $34,800 in Social Security benefits in the year she turns 72. At the beginning of that year, she withdraws her RMD of $81,420.01: [$2,230,908.27 / 27.4].[2] Since 85 percent of her Social Security benefits are taxable, her MAGI is $111,000.01: [$81,420.01 + (0.85 × $34,800)]. Since this MAGI exceeds the $111,000 threshold level, she will have to pay an additional $1,303.20 in Medicare premiums (an additional $89.10 per month in Part B and an additional $19.50 per month in Part D premiums) two years hence. The TDA After Withdrawal column in Table 2 indicates her TDA balance immediately after the withdrawal. The TDA End of Year column indicates her ending real balance after earning a real return of 0.54 percent.[3] As shown in Table 2, Amanda's MAGI is projected to exceed the $111,000 threshold level for 11 years.

In contrast, if her TDA balance at the end of the year she turned 71 was $25,000 lower, then,

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Table 2: Post-Retirement MAGI Projections

Age End of Year	RMD Divisor	MAGI	TDA Withdrawal	TDA After Withdrawal	TDA End of Year
71					$2,230,908.27
72	27.4	$111,000.01	$81,420.01	$2,149,488.26	$2,161,095.50
73	26.5	$111,130.77	$81,550.77	$2,079,544.73	$2,090,774.27
74	25.5	$111,571.15	$81,991.15	$2,008,783.12	$2,019,630.55
75	24.6	$111,678.80	$82,098.80	$1,937,531.75	$1,947,994.42
76	23.7	$111,773.86	$82,193.86	$1,865,800.56	$1,875,875.88
77	22.9	$111,495.98	$81,915.98	$1,793,959.91	$1,803,647.29
78	22	$111,563.97	$81,983.97	$1,721,663.32	$1,730,960.30
79	21.1	$111,616.03	$82,036.03	$1,648,924.27	$1,657,828.46
80	20.2	$111,650.72	$82,070.72	$1,575,757.75	$1,584,266.84
81	19.4	$111,243.24	$81,663.24	$1,502,603.60	$1,510,717.66
82	18.5	$111,240.41	$81,660.41	$1,429,057.24	$1,436,774.15
83	17.7	$110,753.68	$81,173.68	$1,355,600.47	$1,362,920.71
84	16.8	$110,706.23	$81,126.23	$1,281,794.48	$1,288,716.17
85	16	$110,124.76	$80,544.76	$1,208,171.41	$1,214,695.54

assuming the same returns, her MAGI income level would be below $111,000 in every year. Thus, one last year of TDA contributions that were worth $25,000 the year before RMDs begin are projected to cause Amanda to have to pay 11 years of additional IRMAAs, which total $1,303.20 per year (based on 2021 IRMAAs). Assuming Amanda or her heirs eventually pays 25 percent in regular federal income taxes on withdrawals of this last TDA contribution that is worth $25,000 at the end of the year she turned 71, the total additional federal income taxes on this last contribution would be $20,585.20: [(0.25 × $25,000) + ($1,303.20 × 11 years)], which is 82.3 percent of this last contribution's value at the end of the year before RMDs begin. If she lives in a state that has an income tax, then her effective federal-plus-state tax rate on this last year's contribution would be even higher.

The lesson is that if a relatively wealthy single individual decides to contribute to a TDA instead of a Roth account for one more year, it could cause her to pay one more IRMAA spike for several additional years. Similarly, one more contribution to a TDA could force a married couple to pay an additional $2,606.40 per year (based on 2021 IRMAA levels) in Medicare premiums for several additional years.

Who Might Be Affected by IRMAAs?

For 2021, the first IRMAA level is reached when a single individual's 2019 MAGI income level exceeds $88,000. Assume this retiree receives $40,000 in annual Social Security benefits in 2019 and she will turn 72 that year. If her only other source of non-Social-Security income (henceforth, non-SS income) is withdrawals from her TDA, which will be limited to her RMD, then her 2019 MAGI would exceed $88,000 if her end-of-2018 TDA balance was at least $1,479,600.27: [$88,000.01 = RMD of $1,479,600.27 / 27.4 + taxable SS benefits of 0.85 × $40,000]. This example shows that a single individual with a TDA balance of about $1,479,600 whose only source of non-SS income is TDA withdrawals and who limits TDA withdrawals to the RMD would be in danger of having to pay an IRMAA. If this single individual had $20,000 of other non-SS income—such as interest, dividends, capital gains, and pension income—then her 2019 MAGI would exceed $88,000 if her end-of-2018 TDA balance was $931,601.

Let's calculate comparable amounts for a same-age married couple receiving $55,000 in Social Security benefits in 2019. If their only other source

of non-SS income is withdrawals from their TDA, which will be limited to their RMD, then their 2019 MAGI would exceed $176,000 if their end-of-2018 TDA balance was at least $3,541,451. If they had $30,000 of other non-SS income, their 2019 MAGI would exceed $176,000 if the end-of-2018 TDA balance was at least $2,719,451. The lesson is that a household's TDA balance does not have to be exceptionally large before they should worry about how an additional TDA contribution would affect the levels of their Medicare premiums in their retirement years.

Furthermore, as discussed in Reichenstein and Meyer (2021), three calendar years after the death of the first spouse, the surviving spouse will face MAGI income threshold levels for singles, which are generally half as high as for married couples. Suppose the first spouse dies in 2025. Beginning in 2026, the survivor (assumed female for clarity) will file for taxes as a single individual. Her Medicare premiums beginning in 2028 will depend on her 2026 MAGI. Thus, even a retired couple with a relatively modest total of $932,601 in joint TDAs, and that is receiving $20,000 from some combination of interest, dividends, capital gains, and pension income, has the risk that, after the death of the first spouse, the surviving spouse will have to pay the first IRMAA for multiple years.

Left-wing politicians today like to claim that the maximum federal marginal tax rate is 37 percent, and this tax rate is too low from their perspective. Once we recognize that IRMAAs are effectively increases in income taxes, we see that the federal-alone marginal tax rates on the dollars of income that caused a married couple's 2019 MAGI to exceed the second, third, or fourth MAGI income threshold level for 2021 each exceeded 260,000 percent (based on 2021 IRMAAs). Furthermore, these IRMAA spikes in Medicare premiums increase each year. So, these MTRs will soon be higher.

The lesson for relatively wealthy, preretirement age households is that, when deciding whether to save this year in a TDA or a Roth account, they should consider the effective MTR on the additional TDA withdrawals in retirement attributed to this last TDA contribution. As explained in this column, as a retired household's income continues to rise beyond the end of the tax torpedo, there are up to five huge spikes in their MTR due to IRMAAs. Furthermore, there are inherent difficulties when trying to manage a household's MAGI so it approaches but does not exceed a MAGI income threshold level two years hence. For example, consider a married couple that is trying to make end-of-year adjustments in 2021 to try to keep their 2021 MAGI below a MAGI income threshold level in 2023. Since the MAGI income threshold levels for 2023 will not be known until October 2022, this planning process requires estimates. Thus, relatively wealthy households may wish to consider saving in a Roth account instead of a TDA, especially before 2026 when tax brackets are scheduled to increase. Similarly, many of these households should consider making Roth conversions, especially in the next few years before tax rates are scheduled to increase. ■

Endnotes

1. According to Dore (2021), research has found that "roughly 84 percent of those who reached RMD age took only the minimum amount."
2. In this example, I use the divisors (e.g., 27.4) that apply beginning in 2022, so the numbers would apply to this article's readers.
3. As of September 1, 2021, the five-year TIPS real yield was –1.70 percent. Assuming U.S. stocks earn a 5.2 percent annual equity risk premium over intermediate-term Treasuries—which is the 1926–2020 historic average equity risk premium of large-cap U.S.

stocks over intermediate-term (i.e., about five years) Treasury securities—U.S. stocks are projected to earn a 3.5 percent annual real return. International stocks are projected to earn a 4.5 percent annual real return, which reflects the much lower cyclically adjusted price-earnings (i.e., CAPE) ratios of international stocks compared to U.S. stocks. Thus, the expected average annual real return on a 60 percent intermediate-term bond–40 percent stock portfolio, with the stock portion consisting of 60 percent U.S. stocks and 40 percent international stocks, is 0.54 percent.

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