The Two Tax Advantages of Financial Independence

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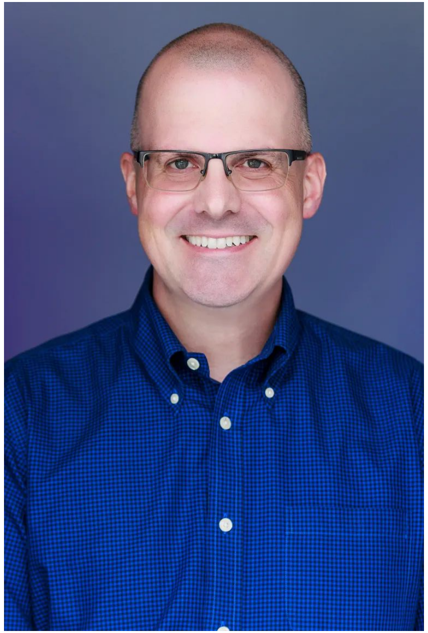

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The First Tax Advantage

Our “Income” and “Payroll” Taxes

Our income and payroll taxes function much like a consumption tax.

The more you consume, the more tax you're likely to pay.

$50,000 Annual Consumption		$100,000 Annual Consumption	
W-2 Earnings	$66,000	W-2 Earnings	$151,000
Fed Income Tax	$7,300	Fed Income Tax	$27,000
CA Income Tax	$2,700	CA Income Tax	$11,000
FICA / Disability	$5,700	FICA / Disability	$13,000
Total Tax	$15,700	Total Tax	$51,000
Effective Tax Rate	23.8%	Effective Tax Rate	33.8%
Tax Rate on Consumption	31.4%	Tax Rate on Consumption	51%

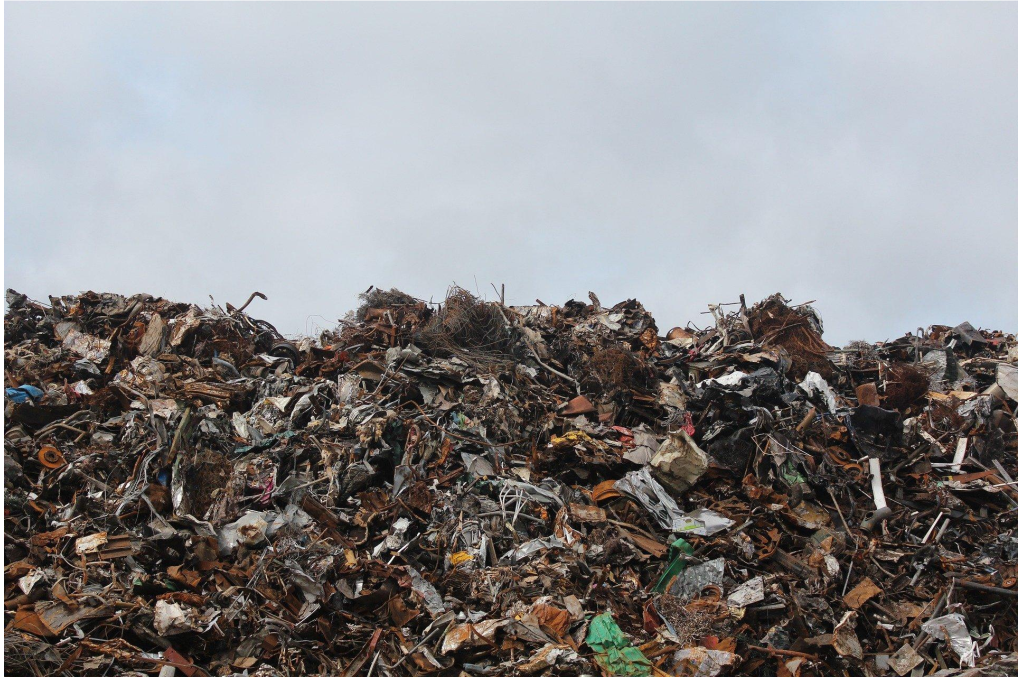
All numbers very approximate, single taxpayer with no dependents.

Stuff

Why does it matter?

The more STUFF you buy, the more tax you are likely to pay.

Why are we buying stuff and paying more in taxes when it's all winding up here anyways?



The Second Tax Advantage

Tax Rate Arbitrage

Deducting an amount for tax purposes at a rate greater than the rate the same amount will later be included in taxable income.

Retirement Planning

There is a high likelihood that contributions to traditional 401(k)s and other traditional, deductible retirement accounts can obtain tax rate arbitrage.

Marginal Tax Rate

The tax rate on the last dollar earned or deducted. Example:

John is single and has taxable income of $180,000. If he earns an additional dollar of income, it will be subject to 32 cents of federal income tax (32% marginal federal tax rate) and 9.3 cents of California taxes (9.3%).

If John contributes an additional dollar to his traditional 401(k), he saves 41.3 cents in taxes.

Traditional 401(k) Contributions

Traditional 401(k) contributions are valuable because they reduce income tax at the taxpayer's <u>marginal rate</u>.

Progressive Tax Brackets and 0% LT Capital Gains/Qualified Dividend Income Rate

Taxable Income Bracket (Single)	Ordinary Tax Rate
$0 - $10,275	10%
$10,276 - $41,775	12%
$41,776 - $89,075	22%
$89,076 - $170,050	24%
$170,051 - $215,950	32%

Taxable Income Bracket (Single)	LT Capital Gains Tax Rate
$0 - $41,675	0%
$41,676 - $459,750	15%
$459,751 and above	20%

Sources: https://www.nerdwallet.com/article/taxes/federal-income-tax-brackets and https://www.nerdwallet.com/article/taxes/capital-gains-tax-rates

The Early Retirement Opportunity

John is retired prior to collecting Social Security. He lives off taxable investments and incurs long term capital gains of $15,000, $4,000 of qualified dividends, and $1,000 of interest.

Tax	Amount
Federal	$0
California	$80

Early Retirement Roth Conversions

John adds on some tax planning. He converts $30,000 from traditional retirement accounts to Roth accounts. That costs him roughly <u>$2,000 in federal income tax</u> (goes through standard deduction, 10% and 12% bracket) and roughly <u>$1,200 in CA income tax</u> (subject to tax in the 1, 2%, 4%, and 6% CA tax brackets).

The tax rate on the Roth conversion is approximately 10.7%.

Tax Rate Arbitrage

Deduct into Traditional 401(k) at 41.3%

Convert from Traditional to Roth at 10.7%

That’s Tax Rate Arbitrage!

Conventional Retirees collecting Social Security and RMDs may have tax rate arbitrage opportunities, but likely not to this degree.

Tax Rate Arbitrage: Fly in the Ointment

Many early retirees will be on an Affordable Care Act medical insurance plan. Those plans qualify for Premium Tax Credits to offset insurance premiums.

Roth conversions can reduce ACA Premium Tax Credits. From a planning perspective, it gets complex, but as a general rule of thumb, use a roughly 10% to 15% tax on the Roth conversion in the form of reduced Premium Tax Credits.

The Fly In the Ointment: May Not be So Bad

- Not every early retiree will be on an ACA plan: TriCare, COBRA, employer retiree plans, other plans.
- Not an issue starting at age 65. Very golden age 65 through 69 window for Roth conversions to get tax rate arbitrage.
- Future ACA changes.
- Roth conversions may be needed to qualify for the PTC.

  California Example

  - *Family of 4 with MAGI under approximately $40K would have to go on Medicaid/MediCal and get no ACA Premium Tax Credit. To avoid this they would need to do Roth conversions.*

Implications of Tax Rate Arbitrage for the FIRE Community

- Dynamic Duo: Max out Traditional 401(k) and Roth IRA or Backdoor Roth IRA.
- HSA: The Ultimate Tax Rate Arbitrage Opportunity
- Consider Delaying Social Security Until Age 70
- Invest in Taxable Accounts for Early Retirement
- Permanent Life Insurance (IULs, etc.) foregoes tax rate arbitrage opportunity.
- Having everything in Roths likely not advantageous
  - Misses tax rate arbitrage opportunity
  - Problem of Roth earnings prior to age 59 ½
  - May need Roth conversions to avoid Medicaid and qualify for ACA Premium Tax Credits

Further Reading

- Dynamic Duo: Max out Traditional 401(k) and Roth IRA or Backdoor Roth IRA: https://fitaxguy.com/roth-401k-vs-roth-ira/
- The Advantages of Living On Taxable Assets in Early Retirement: https://fitaxguy.com/the-advantages-of-living-on-taxable-assets-first-in-early-retirement/
- HSAs: https://fitaxguy.com/top-5-hsa-tips/
- Permanent Life Insurance (IULs, etc.) foregoes tax arbitrage opportunity: https://fitaxguy.com/tiktok-tax-advice/
- Will You Receive an ACA Premium Subsidy: https://www.healthinsurance.org/obamacare/will-you-receive-an-aca-premium-subsidy/
- ACA Plans and Subsidies based on location: https://healthcare.gov/see-plans/
- Solo 401(k)s and Financial Independence. Chapter 13 of Solo 401(k): The Solopreneur's Retirement Account, currently available from Amazon, Barnes & Noble, and other book outlets.

Questions?