Memo to Members of the Vermont Senate Committee on Finance
From: Jason N. Cadwell, CPA/PFS, CFP
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RE: Interplay of Multiple Income Sensitive Programs on Taxpayers

For low-to-moderate income folks, to the extent that they have options for sourcing the cash they need to live, the choices can have markedly different outcomes, based on the resulting income and corresponding tax impact. The reason is that while income sensitive tax policies help people as their income goes down, the converse is equally true; when a low-to-moderate income earner's income goes up, these programs increase their taxes at a high rate.

While this is true regardless of the stage of life someone is in, I'm seeing this issue play out acutely with taxpayers who are in the early stages of retirement. In cases of early retirement (before age 65), whether planned or forced, as is the case with so many folks during the pandemic, the issue is compounded by the potential impact on the cost of health insurance.

What I hope to illustrate is that well-meaning policies have unintentionally created mine fields for the unsuspecting. Given that the policies largely impact low-to-moderate income taxpayers, those with less resources who are often unsuspecting, are very likely to be tripped up.

In considering my observations, I ask that we start with a premise that if two households have the exact same resources, the same asset base, disbursed among the same type of accounts (like IRAs, Roths, bank accounts and investment accounts), then they should pay the same amount of taxes. Put simply, a quote that I heard early in my career stated, "We have no legal responsibility to pay any more than legally required of us." In reality, however, based on the decision as to how these two households source their cash needs (informed or otherwise), the tax implications and therefore the available cash can be significantly different.

For this discussion, I ask that we also agree for simplicity that any cost that is impacted by our level of income is a tax. Therefore, if our cost of health insurance is impacted by the level of income we have, for purposes of this conversation, it is a tax. If our cost of Real Estate Taxes is impacted by our income, it is a tax, of course, but an income tax.

As a final point for context, tax professionals speak about Marginal Tax Rates; the rate of tax that is incurred on an additional dollar of income. If someone has $1,000 of additional income and as a result, they pay an additional $400 of tax, we refer to it as a 40% Marginal Tax Rate (400/1,000). Marginal Tax Rate is an important concept for planning, as it impacts the decisions we make. Such decisions are influenced by the incremental impact they have.

Here is an example of how the various policies impact a client I have worked with in the last month. In this situation, the "baseline" source of income is $22,000 of social security income one spouse is receiving. The question faced is how do they source the additional cash they need to live? Here is how I illustrated their situation:

Assumptions

Married Couple Age 63 and 66
One Drawing Social Security the other Deferring to Age 70
One on Medicare and the Other Accessing Insurance on the Exchange

Impact of additional Income on RE Taxes, HI and Income Taxes

							Marginal Bracket		
Gross Income	Add'l Income	Increase RE Taxes	Increase Health Insurance	Increase Income Taxes	Total Increase $s	Total % Increase	Income	Increased Tax	Marginal Rate
22000					-				
32000	10,000	364	432	-	796	8.0%	10,000	796	8.0%
42000	20,000	564	1,524	-	2,088	10.4%	10,000	1,292	12.9%
52000	30,000	1,008	3,084	2,072	6,164	20.5%	10,000	4,076	40.8%
62000	40,000	1,255	4,584	5,225	11,064	27.7%	10,000	4,900	49.0%
72000	50,000	1,502	6,120	7,426	15,048	30.1%	10,000	3,984	39.8%

Note that going from $22,000 to $42,000 of income, the impact of an additional $20,000 of income (above $22,000 of Social Security Income) is modest (8% to 12.9%). However, an additional $10,000 of income above $42,000 results in increased costs (taxes and health insurance) of $4,076; a 40% tax bracket. Further, the next $10,000 of income generates a whopping 49% of taxes.

How can this happen?

Here are some of the factors:

- At low-income levels, income from Social Security is entirely excluded from income for both Federal Taxes and Vermont Taxes. However, other income sources are considered in this calculation. As other income increases, it can have the impact of increasing the taxation of the Social Security Benefits.

One dollar of additional Income can increase taxable income by 50% or greater, thus accelerating the Marginal Tax Bracket.

- Real Estate Taxes, as we all know, are income sensitive. Vermont provides an adjustment on a homeowner's property tax bill if their income is low. As income increases, the adjustment is reduced at varying rates.

- Likewise, Health Insurance Premiums are reduced at lower income levels and premiums increase as income goes up.

- Though not reflected in the above example, capital gains at lower income levels are excluded from tax for both the Federal and Vermont tax law, but gains are taxed at increasing levels as income goes up.

Compounding the challenges facing taxpayers, the definition of income varies, sometimes significantly, among these different programs. To further complicate the analysis, income as defined by one program can be impacted by the results in the computations of another program. In at least one instance, the impact on the definition of income is impacted by the results of the computation of the benefit resulting a simultaneous equation. It is necessary to know how each program defines income in order to prudently plan.

Most significantly, each of these policies has phase-outs where the benefits decrease precipitously causing "acceleration" income zones as illustrated above where the impact of additional income, considered in total, goes from 12.9% to 40.8% as the income exceeds $42,000.

Given the challenge employers are having with staffing, note that if the taxpayers above sourced additional cash from part-time or seasonal work, income that would be subject to payroll taxes, the additional taxes would increase by 7.65% potentially putting the total marginal tax rate for this taxpayer near or well in excess of 50%.

Without great care, a clear understanding of the complex rules, and for all practical purposes, access to computer software, unsuspecting taxpayers can have unpleasant surprises when it comes to tax time.