

The most taxing rules

Excerpt from New Approaches to Retirement Income Phasing by James Mahaney and Peter Carlson, Prudential Retirement, presented at Pension Research Council Symposium

The rules outlining the taxation of Social Security benefits can be found under Section 126 of the Official Social Security Handbook found on the Social Security Web site (<http://www.ssa.gov>). A brief description lies below. Law changes enacted in 1983 and later in 1993 provide that Social Security benefits received over certain thresholds of Combined Income subject up to 85 cents of a Social Security dollar to taxation. The thresholds were set back in 1983 with the idea that only the wealthy would pay taxes on their Social Security benefits. After the first threshold, up to 50% of Social Security income is subject to taxation. After the second threshold, up to 85% of Social Security income is subject to taxation. The thresholds were not indexed for inflation, and stand at \$32,000 / \$44,000 for married couples, and \$25,000 / \$34,000 for single individuals. The threshold for 50% taxation was established effective for 1983, the 85% for 1994.

The formula includes all of a retiree's income excluding Roth income together with 50% of their Social Security income to determine Combined Income. The amount of Social Security that is taxable is the minimum of three tests: 50% of the Combined Income amount over the first threshold + 35% of Combined Income over the 2nd threshold, or 50% of benefits plus 85% of Combined Income over the 2nd threshold, or 85% of benefits. Combined Income counts all of the income that is normally taxable plus tax-free municipal bond income. Therefore a married couple which has saved diligently within a 401(k) can face a very high marginal tax rate on an additional dollar of IRA income. If the couple is in a 25% tax bracket, they may pay 25 cents on the IRA dollar as ordinary income tax and another 21.25 cents on the Social Security dollar now subject to taxation at 85% ($\$1 \times .85 \times 25\%$). The effective marginal tax rate on that dollar is 46.25%. When current tax rates increase under the sunset provisions scheduled under current law, the effective rate will increase even higher and will exceed 50%. State taxes can push the marginal tax rate even higher.

Some financial journalists have dubbed this concept the "tax torpedo." But just as the tax torpedo can accelerate the taxes due on a retirement income strategy, trading IRA income for Social Security income can create a reverse tax torpedo and drastically reduce taxes. Commonly, a retiree will take Social Security early at age 62 and fund his remaining income needs with IRA withdrawals (which represent his qualified retirement savings). Many of these retirees will find themselves hit by the tax torpedo.

However, an individual who delays taking Social Security and funds their needs out of their IRA or other qualified plan is, in essence, trading IRA income for higher Social Security income. This can provide distinct and measurable tax advantages. In lieu of just assuming that 85% of Social Security income will become taxable, it is important to recognize what type of income is being received. Since Social Security income only counts at a 50% rate into the Combined Income formula, much larger amounts of Social Security can be received before the Combined Income thresholds are met. Therefore, when trading an IRA dollar of income for a Social Security dollar, not only is the IRA dollar no longer present (and thus no tax is due), but less Social Security income is also subject to taxation.