Chapter 2: What you haven't heard before about the taxation of Social Security benefits

Put aside what you think you know about how Social Security is taxed. Based on how the taxation of Social Security benefits is discussed in the marketplace and the media, it is clear that this information is not widely understood. Although the following discussion may become confusing at times, it is being presented so that retirees and their advisors can learn about a way to lower taxes under current law. Lower taxes should translate into higher amounts of after-tax retirement income and an improved standard of living.

Here's the key thing to remember: Social Security income is not taxed the same as IRA income. As a result, you can reduce your taxes by choosing higher Social Security income and lower IRA withdrawals when you develop your strategy for taking retirement income.

COMPARING HOW IRA WITHDRAWALS AND SOCIAL SECURITY INCOME ARE TAXED

Remember that a retiree can choose how and when to take IRA withdrawals and Social Security income. If you choose to take IRA withdrawals first, while delaying the start of Social Security benefits, you're choosing to take higher lifetime Social Security and lower IRA withdrawals. As will be explained below, many individuals who take IRA withdrawals will trigger the taxation of their Social Security benefits that they have already received that year.

Social Security income may be received tax-free. However, once certain income thresholds are met, $25,000 for singles and $32,000 married couples, up to 50 cents of every Social Security dollar becomes taxed. These thresholds are part of the Combined Income formula, also referred to as the Provisional Income formula (See Figure 2). In essence, IRA withdrawals received often push Social Security income over the threshold. When the total income calculated under the Combined Income formula pushes Social Security above a second threshold ($34,000 for singles and $44,000 for couples), up to 85 cents of every Social Security dollar can become taxed.

This method of calculating the taxation of Social Security benefits can create very high marginal tax rates on IRA withdrawals when it is received in retirement. In fact, every additional dollar in IRA withdrawals often causes 85 cents of a Social Security dollar also to become taxable. A 46.25% marginal tax rate applies to that one additional dollar of income if the retiree is in the 25% tax bracket: ($1 (of IRA income) + [$1 (of Social Security income) × .85]) × .25 (tax rate).

Nearly all experts make the "false leap" that the tax on Social Security can't be avoided, and therefore assume that 85% of all Social Security will be taxed as ordinary income once singles and couples hit the retirement income thresholds of $34,000 and $44,000 respectively. However, this is not true!

Upon closer analysis of the Combined Income formula (aka Provisional Income formula), you can see that Social Security income only goes into the formula at a 50% rate. All IRA income and even tax-free municipal-bond income counts at 100%.

Figure 2 What is the Combined Income formula, and how does it work?

The Combined Income formula (also known as the Provisional Income formula) determines how much of a retiree's Social Security benefits are subject to taxation. Up to the thresholds listed below, Social Security benefits are tax-free. Once the first threshold is reached, up to 50% of Social Security benefits are subject to taxation. Once the second threshold is reached, up to 85% of Social Security benefits will be taxed. Listed below are the current first and second threshold limits, respectively.

Single person: $25,000 and $34,000

Married couple filing jointly: $32,000 and $44,000

Modified Adjusted Gross Income (MAGI) plus interest from tax-exempt bonds* plus 50% of Social Security benefits is compared against these thresholds. Note that it is "up to" either 50% or 85% of Social Security benefits that are taxed. See page 10 for how the tax is actually calculated.

**There are additional amounts that must be included in Modified Adjusted Gross Income. Please consult your tax advisor for details.*

So wouldn't it make sense that a retiree could take at least twice the amount of his/her income in the form of Social Security rather than in IRA withdrawals before hitting the "trigger point" where Social Security becomes taxable?

Yes. Actually, a double benefit often occurs for those retirees who would otherwise face the taxation of their IRA and Social Security income. Again, think of trading IRA withdrawals for higher Social Security income. Once you reach age 70 and start taking a much higher Social Security amount, you are taking one additional dollar in the form of Social Security income as opposed to IRA withdrawals.

Better still, you do not pay tax on that Social Security dollar "out of the box," which is not true of the IRA dollar. Instead, the Social Security dollar goes into the Combined Income formula at a 50% rate. So, whereas a 25% tax rate applies, the retiree with IRA withdrawals (and lower Social Security income) is paying taxes as follows compared to a retiree who, instead of receiving that dollar in the form of IRA income, receives it in the form of Social Security.

Figure 3

How the combination of IRA income and Social Security income is taxed:

IRA income		$1
Tax rate	x	25%
IRA tax (A)	=	.25
Additional Social Security subject to tax		$1
% of Social Security income subject to taxes	x	85%
Taxable Social Security income	=	.85
Tax rate	x	25%
Social Security tax (B)	=	.2125
Total tax in cents (A + B):	=	.4625
Total tax in percentage:	OR	46.25%

How every dollar of "delayed" Social Security income is taxed:

Social Security Income		$1
Combined income formula	x	50%
	=	.50
% of Social Security income subject to taxes	x	85%
Taxable Social Security income	=	.425
Tax rate	x	25%
Social Security tax	=	.1062
Total tax in cents:	=	.1062
Total tax in percentage:	OR	10.62%

Why this isn't just a tax benefit at the lower income levels

The example in Figure 3 assumes that the higher Social Security income depicted is taxed at the highest amount—85% of benefits. However, in reality, the Combined Income formula calculates the tax on the smallest of:

1) 85% of the benefits; or

2) 50% of the benefits plus 85% of any excess over the second threshold; or

3) 50% of the excess over the first threshold, plus 35% of the excess over the second threshold.

Many individuals will therefore pay little or no taxes when they delay Social Security and take higher Social Security income and lower IRA withdrawals. Usually, this results from #3 above as the least of the three tests. Consider that a married couple could have $64,000 of Social Security income (counting as $32,000 in the Combined Income formula) before they would ever have "excess over the first threshold."

Although it is not intuitively clear, it is not just retirees who are near the income thresholds of $25,000 to $44,000 who will benefit, but individuals who receive much higher retirement income as well. Prudential's research has found that many individuals with after-tax income up to the mid $90,000 range, can see significant tax savings from delaying Social Security.

Why extending tax deferral isn't always the best route

Conventional wisdom has held that it's always better to delay taking withdrawals during retirement from a tax-deferred product (such as an IRA) for as long as possible. However, this frequently does not hold true, as the tax benefits from much higher Social Security make up for any benefits of delaying the receipt of IRA withdrawals.

The example on the next page represents the dramatic drop in Adjusted Gross Income (AGI) in a given year for someone who delays Social Security and therefore earns a higher amount after age 70.

The retiree is trading IRA withdrawals for higher Social Security income after age 70.

- In Approach A, the retiree took Social Security early and is taking IRA withdrawals.
- In Approach B, the retiree took Social Security later, and is therefore taking $25,000 more in Social Security this particular year and $25,000 less in IRA withdrawals.

This example is being provided to illustrate the dramatic difference in tax being paid after delayed Social Security benefits begin at age 70. To execute this strategy (Approach B), larger IRA withdrawals (than Approach A) would have been taken earlier in retirement to allow the retiree to "afford" to delay Social Security.

Looking at a comparison of the income picture after age 70 is very interesting. Even though the same $90,000 of pre-tax income is provided, Approach B has an AGI of $35,625 less than Approach A.

In other words, shifting $25,000 of income to Social Security removed 142% of that amount from the AGI. In total, AGI was reduced by half. Many retirees could see a 75% drop of actual taxes paid when considering both federal and state taxes. This is the Tax Torpedo in reverse.

Figure 4

Example: Tax impact of delaying Social Security payments/Married couple filing jointly

Approach A: Taking reduced Social Security early and supplementing with higher IRA withdrawals
Approach B: Delaying Social Security

			Approach A		Approach B
	Adjustment amount		$25,000		
	IRA income		$45,000		$20,000
	Social Security	+	$45,000	+	$70,000
	Total pre-tax income	=	**$90,000**	=	**$90,000**
	AGI		$45,000		$20,000
	Plus tax-exempt income	+	$0	+	$0
	Modified AGI	=	**$45,000**	=	**$20,000**
	Social Security benefits		$45,000		$70,000
Test 1	85% of Social Security benefits (Total test 1)		$38,250		$59,500
Test 2	A) One-half of Social Security benefits		$22,500		$35,000
	B) Combined income (aka provisional income)		$67,500		$55,000
	C) Less second threshold		$44,000		$44,000
	D) Excess above second threshold (B-C)		$23,500		$11,000
	F) 85% of excess (D x 85%)		$19,975		$9,350
	Total test 2 (A + F)		**$42,475**		**$44,350**
Test 3	B) Combined income (aka provisional income)		$67,500		$55,000
	G) Less first threshold		$32,000		$32,000
	H) Excess above first threshold (B-G)		$35,500		$23,000
	I) 50% of excess above first threshold (H x 50%)		$17,750		$11,500
	J) 35% of excess over second threshold (D x 35%)		$8,225		$3,850
	Total test 3 (I + J)		**$25,975**		**$15,350**
	Amount includable in gross income (Least of the three tests)		$25,975		$15,350
	Taxable income		$70,975		$35,350
	Difference				– $35,625
	Percentage of income removed from AGI due to trade of IRA income to Social Security				142.50%
	Percentage drop in AGI caused by switch of IRA to Social Security				50.19%