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How Are Social Security Benefits Taxed? A Comprehensive Guide

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Learn how to minimize the taxes you pay on your Social Security benefits. This article explores strategies for reducing provisional income, including timing income events, and the impact of Roth IRA conversions.

By Nick Defenthaler

In my experience, there is typically a high level of confusion when it comes to understanding how Social Security benefits are taxed (consumers AND many financial advisers!). Understanding how other forms of income interact with Social Security is imperative when constructing a tax-efficient retirement income for a client. As we'll explore in this article, the impact other forms of income can have on Social Security can often make or break a financial planning/tax decision in a given year.

Social Security Tax Basics

Are you ready for your head to spin? The taxation formula and application of this formula for Social Security benefits is tricky. Let's start with the formula for what's known as provisional income or combined income. An individual's provisional income will determine how much of their Social Security benefit will be included in their overall income for the year.

- Adjusted Gross Income (AGI) + tax exempt bond interest + ½ Social Security benefit = Provisional Income (PI).

What income counts as AGI? Income from pensions, annuities, employment wages, dividends, interest, capital gains and pre-tax 401(k)/IRA distributions would all be included in AGI.

- Provisional income less than $25,000 for single filers, $32,000 for joint filers = $0 tax paid on Social Security benefits.

- Provisional income between $25,000 – $34,000 for single filers, $32,000 – $44,000 for joint filers, up to 50% of Social Security benefits will be taxable.

- Provisional income above $34,000 for single filers or above $44,000 for joint filers, up to 85% of Social Security benefits will be taxable.

Provisional Income Example

As you can see, there are many moving parts so let's look at an example. Mark and Jenny have pension income of $40,000, distribute $36,000 each year from their traditional IRAs and recently started their Social Security benefits which total $50,000. To determine their provisional income, we would complete the following calculation:

$76,000 AGI (pension + IRA distributions) + $0 tax exempt bond interest + $25,000 (50% of total Social Security benefits) = $101,000 of provisional income.

Given $101,000 of income, $42,500 (or 85%) of Mark and Jenny's Social Security combined benefit of $50,000 will be included in their income for the year.

- Pension = $40,000
- IRA Distributions = $36,000
- Social Security = $42,500

Total Adjusted Gross Income = $118,500

The IRS has a great resource on its website that will help you calculate your provisional income and help forecast the taxability of your Social Security benefit – click HERE to check it out.

Reducing Tax on Social Security

As you can see from the example above, increasing your provisional income will inevitably increase the taxability (and possibly the rate of tax) of your Social Security benefit. The timing of realizing income such as capital gains, IRA distributions or Roth IRA conversions are all important when creating a well-thought-out income plan that takes Social Security taxation into consideration.

We have seen many examples before where, on the surface, a Roth IRA conversion appeared to make sense for a client given their current tax bracket. However, after running the numbers and seeing how much their provisional income would increase as a result of the conversion, we ultimately advised against converting funds to a Roth. In many cases, the increased taxability of Social Security benefits diminishes the value of a Roth IRA conversion and can even be the source of increasing your Medicare premiums and subject you to IRMAA (click HERE to read one of my past articles on this topic).

The impact of taxes on Social Security is a very important aspect of your retirement income plan. There are multiple push-and-pulls when it comes to determining how much tax you'll pay on your benefit and while quite confusing, it's critical your adviser understands these nuances to help ensure your retirement income stream is as tax-efficient as possible.

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Nick Defenthaler, CFP®, RICP®, is a partner, CERTIFIED FINANCIAL PLANNER professional and Retirement Income Certified Professional® at Center for Financial Planning, Inc.® (offices in Brighton and Southfield Michigan). Nick specializes in tax-efficient retirement income and distribution planning for clients and serves as a trusted source for local and national media publications, including WXYZ, PBS, CNBC, MSN Money, Forbes, Financial Planning Magazine and OnWallStreet.com.