Financial, tax, and social security PL

ANNING

A primer for your clients

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Applying tax bracket knowledge can be an essential component to financial, tax, and social security planning. Careful consideration of tax brackets in conjunction with taxation of social security benefits, can open doors to tax-savings opportunities. Even better, no extensive training is needed to understand some key concepts. Simply looking at your tax returns with a greater awareness may allow you to make better informed financial decisions in the future. This article will introduce tax brackets and taxation of social security and reveal how both may be used to reduce your tax bill, ultimately increasing your cash flow at retirement.

Tables 1 and 2 list the 2012 and 2013 tax brackets for a married couple filing jointly[1, 2]. Tax brackets for single individuals have lower thresholds.

As indicated in tables below, there are several tax brackets that represent different amounts of income. It's important to understand that as your income climbs into a higher tax bracket, you owe the higher tax rate only on the difference between your income and the lower bracket's ceiling. For example, if your taxable income in 2012 was $40,700, you will pay 10% tax on the first $17,400 and 15% tax on the next $23,300 ($40,700 – $17,400) for a tax liability of $5,235 [($17,400 x 10% = $1,740) + ($23,300 x 15% = $3,495) = $5,235].

Understanding your tax bracket is very important as will be demonstrated in a case study later on. As a professional, this is one of the first things I look at when analyzing a new client's financial situation. When referencing tax brackets, it's not your adjusted gross income (AGI) that determines your tax liability, but your taxable income. You can find taxable income on the second page of your 2012 IRS Form 1040, line 43.[3] For example, based on the 2013 values for tax brackets, if your AGI is $60,000, it's possible that your taxable income could be $38,000 after adjustments to income, standard/itemized deductions, and exemptions. In this case, the first $17,850 of the income will be taxed at 10% and $20,150 at 15%. ($38,000 – $17,850 = $20,150). Referring to the 2013 tax brackets chart in Table 2, it's apparent that there is room for an additional $34,500 of extra income to be taxed at 15% before crossing over to a higher tax bracket ($72,500 – $38,000 = $34,500).[4]

Table 1: 2012 Tax Brackets	
Tax Bracket	Income
10%	$0–17,400
15%	$17,400–70,700
25%	$70,700–142,700
28%	$142,700–217,450
33%	$217,450–388,350
35%	$388,350+

Table 2: 2013 Tax Brackets	
Tax Bracket	Income
10%	$0–17,850
15%	$17,850–72,500
25%	$72,500–146,400
28%	$146,400–223,050
33%	$223,050–398,350
35%	$398,350–450,000
39.6%	$450,000

Role of Social Security and Your Tax Bracket

Reviewing your tax return is something that becomes more important upon entering the distribution phase in your financial cycle. In order to fully examine your tax return, it's important to familiarize yourself with tax brackets and how taxation of social security is determined. This can potentially reduce your tax bill and increase your cash flow at a time when you may need it most. Reducing your tax bill is just as critical as trying to increase your rate of return on investments.

Let's now focus on taxation of social security benefits (SSB). Taxation of social security also has thresholds but the amount taxed is on a graduated scale. To determine how much of your social security benefit(s) may be taxed, add earned income to unearned income for the tax year. When adding social security as part of the unearned income, be sure to use only one-half of your benefit amount. You can also complete Worksheet 1, *Figuring Your Taxable Benefits,*[5] found in IRS Publication 915. Of significance, tax-free municipal bond interest is included in this calculation, while distributions from a Roth IRA are not.

For taxpayers who are married filing jointly, none of the benefit will be taxed if the resulting number is less than $32,000. If the resulting number is between $32,000 and $44,000, then up to 50% of the benefit will be taxed. Finally, if the resulting number is over $44,000, then up to 85% of the social security benefit will be taxed. Single filing taxpayers will follow the same format with different thresholds of $25,000 and $34,000. (See Example 1 on page 29.)

Example 1 Taxation of Social Security Benefit Calculation:

$41,941 (earned + unearned income excluding SSB) + $15,000 (½ SSB) = $56,941 (Modified Adjusted Gross Income)

From the equation above, we can see that MAGI is over the $44,000 threshold, which means that up to 85% of social security benefits could be taxed. Now, we need to figure out where the 85% threshold is.

The threshold that determines the taxation of 85% of the social security benefit varies depending on the amount of social security benefits received. Example values are calculated in Table 3.

In Example 1, since the social security benefit is $30,000, these individuals will not pay tax on 85% of the benefit until their MAGI reaches $66,941, as per Table 3.

Table 3	
Social Security Benefit of:	Where 85% Threshold is Met
$20,000	$56,941
$30,000	$66,941
$40,000	$78,941

Because the MAGI is less than $66,941, a smaller percentage of the social security benefit will be taxed.

Here's how to calculate the percentage of the social security benefit that will be taxed. According to IRS 2012 Publication 915, page 16, Worksheet 1, *Figuring Your Taxable Benefits*:

$56,941 (MAGI) – $44,000 (SSB threshold) = $12,941

$12,941 x 85% (because MAGI is over the $44,000 SSB threshold) = $11,000

Add lines 15 and 16 = $6,000

$11,000 + $6,000 = $17,000 (Taxable SSB)

From the above equation, we can determine that $17,000 of the social security benefit will be taxed. That's 57% of the $30,000 social security benefit as calculated below:

($17,000 / $30,000) x 100 = 57%

Example 2 Taxation of Social Security Benefit Calculation:

$51,941 (earned + unearned income excluding SSB) + $10,000 (½ SSB) = $61,941 (MAGI)

In Example 2, although IRA distributions are increased by $10,000 and the social security benefit is reduced by $10,000, the combined earned and unearned income of $71,941 did not change from Example 1. Since the social security benefit is less in Example 2, the 85% threshold is reduced to $56,941, as illustrated in Table 3, where essentially, the 85% threshold is met sooner.

Here's how to calculate the percentage of the social security benefit that will be taxed according to IRS 2012 Publication 915, page 16, Worksheet 1, *Figuring Your Taxable Benefits*:

$61,941 (MAGI) – $44,000 (SSB threshold) = $17,941

$17,941 x 85% (because MAGI is over the $44,000 SSB threshold) = $15,250

Add lines 15 and 16 = $6,000

$15,250 + $6,000 = $21,250

Since $21,250 is more than 85% of the SSB, we default to 85% of the benefit and multiply $20,000 (SSB) by 85% to get $17,000.

EXAMPLE 1

Married Filing Jointly (Retired = No Earned Income)[6]	Earned[7] and Unearned Income	Taxation of Social Security Benefit Calculation
Distributions from IRA	$35,941	$35,941
Tax-free Municipal Bond Interest	$5,000	$5,000
Social Security Benefit (SSB)	$30,000	$15,000 (1/2 social security benefit)
Bank Interest	$1,000	$1,000
Totals	$71,941	$56,941
Taxable Social Security		$17,000

EXAMPLE 2

Married Filing Jointly (Retired = No Earned Income)[6]	Earned[7] and Unearned Income	Taxation of Social Security Benefit Calculation
Distributions from IRA	$45,941	$45,941
Tax-free Municipal Bond Interest	$5,000	$5,000
Social Security Benefit (SSB)	$20,000	$10,000 (1/2 social security benefit)
Bank Interest	$1,000	$1,000
Totals	$71,941	$61,941
Taxable Social Security		$17,000

From the equation, we see that $17,000 of the social security benefit will be taxed. In both examples, although the total earned and unearned income did not change and the taxable social security benefits were $17,000, 85% of the social security benefit is taxed in Example 2, whereas only 57% is taxed in Example 1: ($17,000 / $20,000) x 100 = 85%.

As you can see, the second example had a lesser social security benefit and reached the 85% threshold much faster than the first example. In cases such as this, it's important to know where the 85% threshold is to see if it makes sense to do additional tax planning.

Tax Savings Opportunity Case Study

Since we now understand the taxation of social security and how tax brackets work, let's put them together to see how we can save money by reducing tax liability.

Let's begin our case study by looking at two retired taxpayers, Tim and Sandy (see Table 4).

Let's first focus on Method A. Tim has a social security benefit of $20,000 per year. He receives a $46,941 distribution from his retirement account each year.

First, the 85% threshold should be determined. As per Table 3, since his social security benefit is $20,000, the 85% threshold is at $56,941. Tim's MAGI is $56,941, which tells us that he is exactly at the 85% threshold and, from that point on, no more than 85% of his social security benefit will be taxed.

Second, keeping in mind what we learned about tax brackets, Tim's taxable income reportable on Form 1040 is $44,441, which is in the 15% tax bracket, as per the 2012 tax bracket values listed in Table 1.

Since the 15% 2012 tax bracket income range is from $17,400 – $70,700, Tim's taxable income can reach $70,700 and not exceed his current tax bracket. If no tax strategy is implemented, the tax liability for Tim will be $5,794. Without a tax strategy, he will pay this tax liability year after year, *ceteris paribus*, meaning all other factors remaining the same.

Calculation:

$10,000 (½ social security benefit) + $46,941 (earned/unearned income) = $56,941 (MAGI)

Taxable income is calculated at $44,441. Tim's tax liability is $5,794.

Now, consider Method B. Sandy's situation mirrors Tim's, except she takes advantage of tax planning. To reiterate: one-half of her social security benefit plus IRA distributions equals $56,941, which is the threshold where no more than 85% of her benefit will be taxed. Sandy's taxable income is also $44,441. Referencing Table 1, the 2012 values for the 15% tax bracket are from $17,400 – $70,700, so she decides to take an additional $26,259 distribution. ($70,700 – $44,441 = $26,259). This extra income will continue to be taxed at 15% and will not affect her taxation of social security as she has already reached the maximum 85% threshold.

Recognizing this, Sandy will take the extra $26,259 distribution in 2012 and reduce her 2013 IRA distributions by $26,259. Sandy will alternate this each year. It's worth noting that an individual may have less flexibility once he or she reaches age 70½, when minimum distributions are required.

Below you'll see the difference in tax liability for Tim and Sandy over a two-year time period.

Tim: Year 2012

$46,941 is distributed from Tim's retirement account(s) year after year. Tim receives $20,000 in social security benefits; (85% will be taxed = $17,000). His AGI is $63,941 [$46,941 + $17,000 (85% of SSB)]. Tim's taxable income is calculated at $44,441. His tax liability is $5,794.

Tim: Year 2013

Tim has no tax plan and virtually the same liabilities as above.[8]

Sandy: Year 2012

An additional $26,259 is distributed from her retirement account(s) in 2012. Her income is $73,200 ($46,941 + $26,259). Sandy receives $20,000 in social

Table 4: Case Study

Tim Method A: No Tax Plan	Sandy Method B: Tax Plan
Status: Married filing jointly	Status: Married filing jointly
63 years old	63 years old
$20,000 social security benefit	$20,000 social security benefit
$46,941 IRA/other distribution	$46,941 IRA/other distribution
MAGI = $56,941	MAGI = $56,941
Standard deduction	Standard deduction
Taxable income = $44,441	Taxable income = $44,441

security benefits; (85% will be taxed = $17,000). Her AGI is $90,200 [$73,200 + $17,000 (85% of SSB)]. Sandy's taxable income is calculated at $70,700. Her tax liability is $9,741.

Year 2012: Increase in tax liability of $3,947 for Sandy.

In this strategy, Sandy takes an extra $26,259 distribution in 2012, but will not take a $26,259 distribution in 2013.

Sandy: Year 2013

Sandy's income is $20,682 ($46,941 – $26,259). She receives $20,000 in social security benefits. Since her MAGI is under the $32,000 threshold, none of her social security benefits are taxed. Her AGI is $20,682. Sandy's taxable income is calculated at $682. Her tax liability is $68.

The difference in tax liabilities for Tim and Sandy over two years is shown in Tables 5 and 6.

Sandy's tax liability savings are $1,684 over two years, averaging $842 per year. State tax laws also have to be considered because they vary by state.

Conclusion

As illustrated in this article, it may make sense for you to postpone taking social security benefits in certain situations. Your benefit amount will not only increase, but you may additionally pay less in taxes as the 85% threshold changes. As financial situations differ, these strategies may not be applicable for everyone. The important thing to remember is that by applying the knowledge you have regarding tax brackets and taxation of social security benefits, you'll be able to spot issues and further seek assistance from a tax professional to help you make a better informed decision.

Table 5: Tim's Tax Liability
Tax Year 2012 = $5,794
Tax Year 2013 = $5,699
Total Liability = $11,493

Table 6: Sandy's Tax Liability
Tax Year 2012 = $9,741
Tax Year 2013 = $68
Total Liability = $9,809

End Notes

1. Publication 505: *Tax Withholding and Estimated Tax*. Internal Revenue Service, July 2012. pp. 42. Web. 8 Feb. 2013. <http://www.irs.gov/pub/irs-pdf/p505.pdf>.
2. Landes, Luke. Updated: 2013 Federal Income Tax Brackets And Marginal Rates. *Forbes Magazine*, Jan. 5, 2013. Web. Feb. 8, 2013. <http://www.forbes.com/sites/moneybuilder/2013/01/05/updated-2013-federal-income-tax-brackets-and-marginal-rates/>.
3. Form 1040: *U.S. Individual Tax Return*. Internal Revenue Service, 2012. Web. Feb. 5, 2013. <http://www.irs.gov/pub/irs-pdf/f1040.pdf>.
4. For tax brackets, long-term capital gains and qualified dividends will have a different outcome as they are currently taxed at their own tax schedule. Calculations in this article do not use long-term capital gains or qualified dividends.
5. Publication 915: *Social Security and Equivalent Railroad Retirement Benefits*. Internal Revenue Service, Dec. 2012. pp. 16. "Figuring Your Taxable Benefits". Web. Feb. 5, 2013. <http://www.irs.gov/pub/irs-pdf/p915.pdf>.
6. These strategies are for individuals who are not currently working, or for those who are working and over their full retirement age (FRA).
7. It's important to analyze earned income prior to full retirement age (FRA), as the social security benefit will be reduced when earned income exceeds the thresholds provided by the Social Security Administration.
8. Liability may change minimally due to yearly adjustments in the standard deduction, exemptions, and social security benefits.

Marty Urbanowicz, CFP®, EA is the owner of Rock Martin Private Wealth Management. He is a Certified Financial Planner® licensed in the states of Arizona, New York, Colorado, California, Texas, and Hawaii with expertise in tax preparation and planning, estate and college planning, as well as investment strategy and planning. As an enrolled agent Marty is empowered by the U.S. Department of the Treasury to represent taxpayers before all administrative levels of the Internal Revenue Service for audits, collections, and appeals. He additionally received advanced certification in college planning strategies through investing, asset shifting, and tax planning. Marty currently teaches social security and college planning classes throughout the community demonstrating how to maximize benefits by implementing tax and investment strategies. He earned his Bachelor of Science degree in Economics with a concentration in Finance from the State University of NY College at Buffalo. He has a minor in engineering science providing an analytical component to his business background. Marty is a member of the National Association of Tax Professionals. Before founding Rock Martin Private Wealth Management, he was an Investment Advisor for Morgan Stanley and Clearplan Financial.