"What is the Social Security "Tax Torpedo" and Ways to Avoid It!"

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(6 of 6-part series)

Tax planning in the retirement years can be challenging and takes some paying attention to detail and close monitoring each year. We wanted to cap off our 6-part Social Security Series by helping you understand the taxability of social security and how to avoid it when possible. We are often asked about the taxability of Social Security and whether or not someone will have to pay taxes on all or a portion of their benefits. There is not exactly a straight forward answer as some will pay taxes on a large portion of it, some will pay a little and others will pay no taxes at all on their benefit, and it all depends on the rest of the income picture for that year. So this is why paying close attention can help you avoid paying a larger percentage of taxes than necessary on your Social Security benefit and avoiding the "Tax Torpedo."

Social security benefits were initially exempt from federal taxes, but in 1983, they became partially taxable. Later in 1993 another threshold was added that further increased the percentage of benefits that would be taxed. In order to determine the portion of your benefits that are subject to taxes you need to calculate your "provisional income." Your provisional income is your adjusted gross income (not including your social security), plus any tax-free interest income, up to either 50% or 85% of your social security benefit. For a married couple filing jointly, the first threshold is a provisional income of $32,000. If you fall under that level, you would pay no taxes on your social security benefits. If your provisional income is between $32,000 and $44,000 you would pay taxes on up to 50% of your benefits. And finally, if your provisional income is over $44,000 you would pay taxes on up to 85% of your benefits. As you can see, managing these thresholds each year will allow you to pay substantially less on you overall benefits and can keep more money in your pocket.

What are your chain of events that cause your tax rate to jump substantially?

The social security "Tax Torpedo" is a chain of events that can cause your tax rate to jump substantially when you are forced to take your Required Minimum Distribution (RMD) from your retirement account at 70 ½ years old. This RMD will force your income to go up, which then forces you to pay taxes on your Social Security or a larger portion of those benefits. Many people get the same: "avoid paying taxes as long as you can on your retirement benefit and don't touch it until you have to at 70 ½ years of age." While these may be right for higher earners, what most don't realize is that this only makes that tax deferred account grow to a larger amount and forcing the RMD amount up, creating more income, and more tax on that income and social security benefits.

For example, if you were just below the $32,000 threshold noted above and you waited to draw from your tax deferred retirement account until your RMD age and were then forced to take out $10,000 that year, this would then force half of your social security benefit to be taxed. So not only would you pay additional income taxes on the $10,000 RMD amount but then you would also be paying additional income taxes on half of your social security benefits. This compounding affect is known as the tax torpedo being the tax rate on that $10,000 is not just income taxes, but it is also the increased taxes on your social security benefits as well. So what are the ways that you can try to avoid this situation? We will go through 3 potential strategies for you to consider.

3 Considerations for Avoiding the Social Security Tax Torpedo

1. **Contribute more often to Roth IRA accounts** if you are under 70 years of age. Contributions to Roth IRA accounts are after-tax contributions with no upfront tax benefit. However, if you can forego the benefit up front, you will get to pull funds from this account on a tax free basis. This would be tax free withdrawals on what you put in as contributions, PLUS all of the earnings. Having an account that you can pull from to fill an income need without that distribution being counted as ordinary income will give you the tax diversification that is often needed in retirement. Having this flexibility will greatly enhance your taxable situation each year. Note that unless certain criteria are met, Roth IRA owners must be 59½ or older and have held the IRA for five years before tax-free withdrawals are permitted. Otherwise, taxes and a 10% penalty may apply to earnings withdrawn.

2. **Take money out of pre-tax retirement account** between 59 ½ and 70 years of age. Yes, you heard me right, I'm telling you to consider taking funds from these accounts and pay the taxes on them now in an effort to keep the account value down and ultimately the RMD amount lower when Uncle Sam forces you to take it out at 70 ½. This will again allow you the flexibility to control the tax situation each year depending on the rest of your income to keep you in the lowest tax bracket possible. One important thing to note here is that if you are not on Medicare yet and are buying your health insurance through the exchange, this additional income could reduce your tax credits on that exchange plan. So please keep that point in mind if you find yourself in that situation.

3. **Delay Social Security Benefits!** We have talked about the benefits of this before and it holds true here again. Delaying your benefits will force you to get your income elsewhere, more than likely from pre-tax retirement accounts as noted in #2 above. Not only would you be increasing your Social Security because of the delayed credits, but you would also be reducing your mandatory IRA withdrawals down the road. Or better yet, if you have done the proper planning and have taxable investments, you could take from that taxable investment account for your income needs, and then do partial conversions each year from your pre-tax dollars to a Roth IRA. This would also keep the mandatory withdrawals down as there are no RMD's on your Roth IRA assets. You would continue to pursue growth of your asset in an account while controlling your tax situation. Note that the converted amount is generally subject to income taxation, and each converted amount may be subject to its own five-year holding period in the Roth IRA. Qualified plan and Traditional IRA account owners should consider the tax ramifications, age and income restrictions in regards to executing a conversion to a Roth IRA.

Doing the proper tax planning in retirement requires paying attention to detail and looking at your situation on a year by year basis, however the benefits can be very rewarding. Your Social Security benefits play a large part in your taxable situation and remember that your situation is just that, YOURS! You cannot go off the advice from a friend or neighbor as their circumstances may seem similar but are more than likely very different in the details. Make sure that you are doing this planning each year ahead of your retirement years and during your retirement years to ensure that you keep more of your money in your pocket!

Scott and his team, specialize in Wealth and Retirement Planning for individuals and couples who are serious about developing a plan for their future. While they are well regarded for their expertise in social security, this is just a piece of what will be covered when choosing to work with SA Piggush. Your experience will be unlike any other relationship with an advisor. They can be reached at (815) 907-7360 or you can visit them on the web at www.sapiggush.com.

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