FINANCIAL

When You Retire, Will Your Social Security Benefits be Taxed...and **Why Should You Care?**

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Most Americans are not aware that Social Security benefits have not always been taxed. Not until 1983 was there a tax on the once sacred retirement benefit. In a bipartisan compromise after recognizing the impending insolvency of Social Security, President Ronald Reagan and then Speaker of the House, Tip O'Neill, agreed to allow up to 50% of benefits to be taxed. That opened the door. Later in 1993 during his first term, President Bill Clinton raised the taxation percentage to 85%. This article will discuss the impact those taxes have on retirees.

Before you can implement defense strategies one must first understand how the IRS thinks. There is a calculation that is performed specifically to determine whether you are over the prescribed income threshold. About this time you are saying, "There is an income threshold?" Yes, if married and filing jointly, it's $44,000 and if filing single, it's $34,000. So what does that really mean? The IRS, as one of its last calculations when calculating your taxes, determines your "Provisional" income. If you are not familiar with that term, just read on.

Provisional income simply stated, is the calculation to determine if your SS will be taxed. First, they add all your 1099 income. This includes interest, dividends, short- and long-term capital gains, as well as any municipal bond income. (You read correctly. ALL muni-bond income counts as provisional income.) Next, the IRS counts all the "Ordinary" income from your qualified plans and retirement accounts. Then to cap it off, they add insult to injury and count 50% of your SS benefit. If you are married and it exceeds $44,000 or single and it exceed $34,000, then congratulations–up to 85% of your benefits will be taxed at the highest tax bracket you are in.

So, now that you know what Provisional income is, let's have some fun with math. First we have to make some assumptions. Let's say you are married filing jointly and your SS income is $25,000. We have calculated your provisional income and it exceeds $44,000. That means 85% of your income or $21,250 is now added to your income at the highest marginal rate. We assume if you are in the 24% marginal bracket, your SS tax bill is $5,100. You now discover you have a $5,100 hole in your income. So how do most people respond? They withdraw more money from their IRA's and saving accounts. Here is an important question. When they withdraw more income from their

IRA account(s), if tax rates have risen, how much more will they have to withdraw?

So, why should you be concerned about preventing your provisional income from exceeding the threshold(s)? According to David McKnight, best selling author of the Power of Zero, retirees that allow their SS to be taxed tend to run out of money faster than those that do not.[1]Why? Because the mere act of withdrawing more puts that much more pressure on the assets to perform. To make matters worse when tax rates go up (assuming Congress does nothing), how much more will retirees have to withhold to compensate for even more taxes?

Not to pile on here, but if you listen to other experts like David Walker, former Comptroller General, and Ed Slott CPA, retirement expert, tax rates beyond 2026 are destined to increase due to the fiscal spending policies of the government. Ed Slott warns, “Those who saved most diligently, though, will soon realize that a substantial chunk of those tax-deferred retirement savings are sitting ducks for a revenue-hungry Uncle Sam. In fact, as your 401(k) or IRA funds grow, so does the government’s share since it is a partner, Uncle Sam can increase his partnership percentage of your tax-deferred savings whenever he needs more money, and that day is coming soon. The question is then, are you prepared?”[2]

So what’s the answer? Stay tuned for Part II in next month’s Community Spirit magazine for strategies that can insulate and buffer you from the impact of higher taxes. (2423086RM–Feb21)