

Taxation of Social Security Benefits

At one time, all Social Security retirement benefits were tax free. However, the tax rules are not quite as simple today; instead, benefit recipients fall into one of three categories:

- For most recipients, benefits remain tax free.
- For some recipients, up to 50 percent of benefits are taxed.
- For the most affluent retirees, up to 85 percent of Social Security retirement benefits are considered taxable income.

Whether benefits will be taxable depends on a person's income tax filing status—single or married filing jointly—and the amount of his or her modified adjusted gross income (AGI). Individuals whose total income (from practically all sources, including investment income and pensions) exceeds certain threshold limits may be surprised to discover that part of their Social Security retirement benefits will be taxed.

Determining the Amount of Taxable Benefits

The amount of Social Security benefits that are taxable depends on the extent to which a person's modified AGI, plus half of his or her Social Security benefits, exceeds specified threshold levels.

- Benefits will not be taxed if a single person's modified AGI plus one-half of his or her Social Security benefits is less than \$25,000 (in the case of married couples filing jointly, the threshold level is \$32,000).
- Up to 50 percent of Social Security benefits are taxed if income is between \$25,000 and \$34,000 for single filers and \$32,000 and \$44,000 for joint filers.
- Up to 85 percent of Social Security retirement benefits are taxed if income is more than \$34,000 (if single) or \$44,000 (if married filing jointly).
- Individuals who are married but file separate returns are generally taxed on 85 percent of their Social Security benefits.

For purposes of this test, **modified adjusted gross income** includes the following:

- wages
- interest and dividend income
- taxable pensions
- other investment income
- wages from part-time or full-time work
- tax-exempt interest income
- excludable interest income from U.S. savings bonds
- excludable foreign-earned income

Example

Brian and Linda are married and receive Social Security retirement benefits. Last year, their income was \$50,000:

- \$12,000 from Linda's part-time job
- \$13,000 in interest and dividends
- \$20,000 from Brian's defined benefit plan
- \$5,000 in tax-exempt interest from municipal bonds

They also received \$20,000 in Social Security retirement benefits, bringing their total income to \$70,000. To calculate the tax applicable to their retirement benefits, the full \$50,000 in income is considered to be their modified AGI. The modified AGI (\$50,000) plus one-half of Brian and Linda's Social Security benefits (\$10,000) equals \$60,000. Because this is more than the \$44,000 threshold, 85 percent of their Social Security benefits—\$17,000—is subject to income tax.

Unlike other numerical figures in the Tax Code, these threshold levels are not indexed for inflation, which means that more and more retirees will fall into the group whose Social Security retirement benefits are taxed. Calculating whether a client's benefits will be taxable one day requires you to predict what his or her future earnings will be. This can be critical to retirement planning, because tax-free benefits obviously go much further than those that are subject to tax.

Minimizing the Tax on Social Security Benefits

The idea of paying taxes on up to 85 percent of Social Security retirement benefits may not sit well with many people. However, clients who face this scenario have options for reducing or eliminating this tax. For example, a client can reduce his or her AGI by shifting assets that would otherwise produce taxable earnings into a nonqualified, tax-deferred investment, such as a deferred annuity, since annuity accumulations and reinvested annuity interest earnings are not included in modified AGI for Social Security tax purposes. Consequently, to the extent that a person can afford to relinquish current income, diverting funds into an annuity could significantly reduce or eliminate the tax on Social Security retirement benefits.