3 Social Security Income Tax Myths…

… and how advisors can dispel them for their clients

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More and more retirees are having their net "take-home" retirement income eroded due to taxation of their Social Security income benefit. Many retirees are unaware that up to 85% of Social Security income can be taxed.

Furthermore, they may not even be aware that they can have significant control over reducing, or even all together eliminating, this taxation of their retirement income stream. However, with some advance planning, a considerable segment of retirees receiving their Social Security income may be able to reduce, or even eliminate, the taxation of their Social Security benefit.

Clearly, then, we should highlight three myths that financial advisors should consider sharing with clients. Please keep in mind that this article just touches on the complicated subject of Social Security income taxation, and the financial elements that determine if, and/or how much, this tax will be.

MYTH 1 – Taxes On Your Social Security Income Can't Be Controlled

This is incorrect. Due to the diligence of a growing number of financial advisors and heightened media coverage, more and more retirees are beginning to understand the wisdom of evaluating their Social Security election decision in order to optimize/maximize their lifetime income. They may even be aware that up to 85% of the income they receive from Social Security can be taxed at their respective income tax bracket. However, they may not realize that with some advance planning, this tax can potentially be controlled (i.e. moderated or all together eliminated).

The amount of Social Security income that is taxed is dependent on "Combined Income", which includes all adjusted gross income (AGI), and non-taxable interest, but only half of Social Security income. In other words, Social Security income is given a tax preference relative to other sources of retirement income. By controlling earned income, and also the allocated ratio of your investments holdings in income vs. growth and taxable vs. nontaxable accounts, retirees can control their AGI and therefore their combined income.

In addition, by prioritizing fund withdrawal sequences from different types of accounts (i.e. non-retirement versus retirement accounts) retirees can potentially decrease their Social Security income taxes. This, in turn, can have the effect of increasing the longevity of their portfolio or the value of their legacy. Pre and early retirees work hard to save for retirement. At this life stage, it is paramount that they reassess their investment decisions and placements.

Moreover, they need to be informed on how to maximize and optimize their Social Security income election in the context of how taxes will impact this income stream. Uninformed investment placements and withdrawal strategies may erode your clients' hard earned retirement savings.

MYTH 2 – My Accountant Will Show Me How To Minimize My Social Security Income Taxes

This, by and large, is incorrect . Although it may be true on occasion, most accountants are occupied with the 'here and now' of evaluating current tax year documents, entering this information on 1040 tax returns, and calculating the client's annual income tax obligation.

Many accountants are not typically involved in financial planning or forecasting future income amounts and tax liabilities. They may not be aware of certain retirement accounts that retirees have if they are not yet generating reportable taxable income.

Case in point, consider asking your client(s) if their CPA has asked them what their 401(k) and/or IRA current balances are and what the impact of the distributions of these balances will be on the taxation of their Social Security income benefit. For instance, once retirees with IRAs reach age 70 ½ they are subject to take Required Minimum Distributions, RMDs. These withdrawals can significantly increase clients' AGI and therefore the taxation of their Social Security income benefit.

It is more common for financial advisors to be the professionals guiding their clients with retirement income planning. This process involves looking

at the entire “big picture” of retirement finances and also the forecasting necessary to manage the taxation of Social Security income benefits. Advisors who are knowledgeable about Social security income taxation, and who let accountants know they can help with this, will have the valuable opportunity to guide their clients to a more financially secure retirement.

MYTH 3 – Fewer People Are Paying Taxes On Their Social Security Income

This is incorrect (Figure 3). The Social Security tax, which is often referred to as a “Stealth Tax”, has not been adjusted for inflation over the years.

Social Security income becomes taxable when an individual’s or married couple’s Combined Income (described in Myth 1 above), reaches a certain threshold. The first threshold indicates that up to 50% of Social Security income can be taxed and the second, up to 85%. The first 50% threshold was enacted in 1983 and the second 85% threshold in 1994, and neither has been adjusted upward for inflation.

Tax on Social Security income benefits is often referred to as a “Stealth Tax” because it literally sneaks up on retirees who are caught unaware until it is too late. If Combined Income is over one of the thresholds, a complicated three-way test (beyond the scope of this paper) is applied to determine how much of the income is taxed.

As we have shown, the threshold amounts for singles are $25,000 and $34,000. These amounts, as well as those for married couples, have not changed since 1994, over 20 years ago. Thus, over the years this has resulted in more and more individuals being subject to taxation of their Social Security income. As the average wage and annual income has increased over the years, more and more retirees are continually being impacted by this tax.

Along with wage increases, income from assets, pensions, rentals, and many other sources have inflated. These inflated income streams are commonly included into the combined income calculation which impacts the taxation of retirees Social Security income benefit.

The full affect is often not realized until they are well into retirement with their Social Security, investments, and withdrawal strategies already in place.

Conclusion

Understanding the taxation of Social Security income benefits is a valuable topic for financial professionals to master. Clients are looking for advisors who understand the complete “big picture” of their retirement financial planning.

Preservation and continued growth of wealth is one part, but smart asset placement, sequence of withdrawal strategies, and especially understanding the taxation of all pieces of this complicated puzzle are critical to a sound and secure retirement plan. ♦