Chapter 14: Social Security or Insecurity?

Under the current law, most of us won't pay federal or state income taxes on our Social Security benefits. However, if we have significant income, we might pay taxes on part of our benefits. Here are the rules for applying federal income taxes to Social Security benefits.

Do I pay federal and state income taxes on my Social Security retirement income?

Maybe, depending on how much other income we have. And it gets really messy – as usual, the government didn't make it simple. Here's how it works.

- We start with our adjusted gross annual income from our tax return, add 50% of our Social Security benefits, add tax-exempt interest, and add some other miscellaneous items for work outside the U.S.

- Compare the result to an earnings limit. If we're single, the limit is $25,000, and if we're married the limit is $32,000.

- If the result is under the limit, none of our Social Security benefit is taxed for the purposes of the federal income tax. If the result is over this limit, then we're taxed on an amount which is the lesser of (A) or (B):

   A. half our Social Security benefit, or
   B. half of the amount by which the above calculation exceeds the limit.

- Note that earnings here are different than for the earnings test. For the earnings test, we don't count pension benefits, withdrawals from IRAs or 401(k) plans, or investment

- earnings. However, these earnings count for the purpose of determining whether our Social Security benefits are subject to federal income taxes.

There's more, but first let's look at an example.

Suppose we're married, our pension and investment income is $30,000 per year, and our Social Security income is $14,000 per year. Half of $14,000 is $7,000 – add this to $30,000, for a result of $37,000. This is $5,000 more than the limit of $32,000. So we increase our taxable income by the lesser of:

A. $2,500 (half of $5,000), or
B. half of our Social Security benefit, which is $7,000.

So, we add $2,500 to our taxable income for the year. Our taxable income is then $32,500 ($30,000 plus $2,500) for the purposes of calculating our federal income taxes.

Unfortunately, if we make a lot more than the above limits, more calculations apply. Here's how this works.

- Start with the same adjusted gross income plus half of our Social Security benefit.

- Now we compare it to a higher limit - $34,000 for singles, and $44,000 for a married couple.

- Now we add to our taxable income the lesser of (A) or (B):

    A. 85% of our Social Security benefit, or
    B. 85% of the excess of our adjusted gross income over the higher limit, plus the lesser of:

– half the benefits, or
– $4,500 ($6,000 for married couples).

Whew! This is enough to make an accountant cry uncle! Let's look at an example.

Suppose we're single and we make $50,000 per year from pensions and withdrawals from 401(k) plans. Also suppose our annual Social Security income is $16,000. Take half of this amount, $8,000, and add it to $50,000, for a total of $58,000. This exceeds the higher limit of $34,000 for singles by $24,000. Now we add to our taxable income the lesser of (A) or (B):

A. 85% of our Social Security benefit, or $13,600, or
B. 85% of $24,000, which is $20,400, plus $4,500, which is $24,900.

So, to determine our total taxable income, add $13,600 to $50,000, for a total taxable income of $63,600.

This is complicated, but we can deduce some strategies to make the best of this situation.

- If, during our sixties, we have income that is well over the higher limits, this is another reason to delay receiving our Social Security benefits as long as possible, until age 70. By then, we might not be making as much other income, and we've maximized our Social Security income by delaying it until age 70.

- We should pay attention to the timing of large withdrawals from our 401(k) plan and IRAs. These can cause our total income to exceed the higher limit amounts.

- If we still have a mortgage on our house, we might be better off withdrawing from our 401(k) plan and/or IRA to pay off the mortgage before starting our Social Security benefits.

This significantly reduces our *E*, while also reducing future *I* such that our Social Security benefits might not be taxed.

Now, having said all this, let me repeat that we shouldn't let tax rules drive our lives. If our Social Security benefits are taxed, it's not the end of the world. We should first try to figure out a way to do what we want to do with our lives, and then try to minimize our federal and state income taxes.

This document is intended to complement and reinforce the themes in Live Long & Prosper! I don't intend for it to make complete sense without reading the book.