

AVOIDING SOCIAL SECURITY TAX TRAPS

Originally, Social Security was tax free. But times have changed, and now many taxpayers can expect to see at least a portion of their Social Security income make its way onto the taxable income line of their 1040s. As tax laws change going forward, there is an increasing likelihood that more and more of your Social Security could be subject to taxation.

In this article we'll explore why and how Social Security benefits become taxable and provide some tips to help you dig your way out of the trap.

Income Thresholds

There are two separate income thresholds for filers that will determine whether they have to pay tax on their Social Security benefits. Here is a breakdown of the categories:

	Income	Percentage of Social Security Taxable
Single, Head of Household, Qualifying Widower and Married Filing Separately (i.e., spouses lived apart the entire year)	Below \$25,000	All SS income is tax-free
	\$25,000 - \$34,000	Up to 50% of SS income may be taxable
	\$34,000 and up	Up to 85% of SS may be taxable
Married Filing Jointly	Below \$32,000	All SS income is tax-free
	\$32,000 - \$44,000	Up to 50% of SS income may be taxable
	\$44,000 and up	Up to 85% of SS may be taxable

Calculating Your Income Level

Filers in either of the first two categories must compute their provisional income - also known as modified adjusted gross income (MAGI) - by adding together tax-exempt interest (such as from municipal bonds), 50% of the year's Social Security income, as well as any miscellaneous tax-free fringe benefits and exclusions to their adjusted gross income and then subtracting adjustments to income (other than education-related and domestic activities deductions.)

You can use IRS worksheet 1341 to estimate the amount of taxable Social Security income you will have. Qualified plan participants who also contributed to a deductible IRA must use the worksheets found in IRS Publication Form 590 instead. Those who file as Married Filing Separately and lived at any time with their spouse during the year must include the lesser of

85% of Social Security benefits on Line 1 of Form 1341 or 85% of the calculated provisional income from the same worksheet.

Example 1

Bill Johnson is single, he earned \$19,500 for the year and received \$2,000 of interest income and \$1,500 from gambling winnings. He also receives \$10,000 in Social Security income. ($\$19,500 + \$2,000 + \$1,500 + \$5,000 = \$28,000$)

- **Bill's provisional income will come to \$28,000. He therefore may have to pay taxes on up to 50% of his Social Security.**

Example 2

Richard and Lori Jackson have joint earned income of \$48,000 and \$4,000 of interest and \$3,000 of dividends. Their Social Security benefits come to \$20,000. ($\$48,000 + \$4,000 + \$3,000 + \$10,000 = \$65,000$)

- **The Jackson's MAGI is therefore \$65,000. They may have to pay tax on up to 85% of their Social Security benefits.**

How to Lower Your Social Security Taxes

There are several remedies available for those who are taxed on their Social Security benefits. Perhaps the most obvious solution is to reduce or eliminate the interest and dividends that are used in the provisional income formula. In both of the examples shown above, the taxpayers would have reduced their Social Security tax if they hadn't had declarable investment revenues on top of their other income. Therefore, the solution could be to convert the reportable investment income into tax-deferred income, such as from an annuity, which will not show up on the 1040 until it is withdrawn.

If you have \$200,000 in certificates of deposit (CDs) earning 3%, which translates into \$6,000 a year that will be counted as progressive income.

But the same \$200,000 growing inside an annuity will effectively yield reportable interest of \$0 when computing provisional income. Therefore virtually any investor that is not spending all of the interest paid from a CD or other taxable instrument can benefit from moving at least a portion of his or her assets into a tax-deferred investment or account.

Another possible remedy could be to simply work a little less, especially if you are at or near the threshold of having your benefits taxed. In the first example listed above, if Jim were to move his taxable investments into an annuity and earn \$1,000 less, he would have virtually no taxable benefits. Shifting investments from taxable accounts into a Traditional or Roth IRA will also accomplish the same objective, provided funding limits have not been surpassed.

Conclusion

There are many rules concerning the taxability of Social Security benefits, and this article attempts to cover only the major rules and issues related to this topic. For more information on this topic, visit the IRS website and download IRS publication 915 or consult your tax advisor.