How to Cut Taxes on Your Social Security Benefits

Some clients will always pay tax on 85% of their Social Security benefits. That's the maximum that can be taxed: for high-income seniors, $20,000 of benefits would generate $17,000 of taxable income.

Conversely, some clients will owe no tax on their benefits because of relatively low income in between, savvy planning may help- seniors reduce the tax they owe on Social Security benefits.

CRUCIAL FORMULA

The key is a formula known to the Social Security Administration as "combined income," also called "provisional income." To get this amount, add adjusted gross income (AGI) to any nontaxable interest income and one-half of Social Security benefits. For example, with AGIK of $30,000 plus $10,000 of tax-exempt interest and $18,000 of Social Security benefits, combined income is $49,000 ($30,000 + $10,000 + $9,000.)

Depending on filing status, a series of combined income thresholds ranges from $25,000 to $44,000; the portion of Social Security benefits subject to income tax grows from 0% to 85%, as combined income clears those thresholds. When clients have combined income in the threshold range or slightly higher, tactics to reduce AGI may have the extra advantage of lowering the tax on Social Security benefits.

"Here is a strategy for a couple with substantial IRAs and little non-qualitied liquidity," says Norma Jean. Assume they want $80,000 of annual pre-tax cash flow. Their Social Security benefits total $27,000 so they can withdraw $53,000 from taxable IRAs each year. Over four years they would pay total federal and state income taxes (4.8% in Indiana) of $38,585."

With some planning, this couple might take more ($72,500) from their IRAs in alternate years and less ($33,500) in the following years. "By stacking IRA distributions every other year," says Norma Jean, "they will use part of the prior year's distribution to fund the next year's household cash flow. This method can reduce their provisional income and save tax in the low distribution years. They'd have the same amount to spend but their total income taxes would be $34,266 for the four years, for a savings of $4,319."

MIXING WELL

"One of my single clients needs $3,800 per month in retirement, and her monthly Social Security income is $2,100. We decided that she should draw $1,700 per month from her investments as a supplement."

The plan is to take out only as much in taxable distributions from the client's IRA each year to keep her Social Security from being taxed. "The balance will come from her other accounts," she adds.

Thus, Ms. Rector might run the numbers and determine that this client can take, say $700 a month from her traditional IRA this year and still keep combined income below the threshold for taxation of benefits. (Starting at age 70-1/2, clients will have to take at least the required amounts from their IRAs.) Then the client would take the $1,000 monthly shortfall from other accounts (perhaps by taking untaxed distributions from money market funds or by selling securities with no unrealized gains) to bring the monthly total to the desired $1,700, without triggering income tax on her Social Security benefits.

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