ThinkAdvisor

Beware the Social Security 'Tax Torpedo'

The combination of different income types in retirement can create some really ugly distortions in tax rates.

By Joe Elsasser

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If you're an advisor who has done Social Security planning, I'm sure you've heard of the "Tax Torpedo." One of the earliest references was from **Scott Burns**, a columnist who wrote a lot about Social Security well before most financial advisors were paying attention.

As a refresher, Social Security income by itself is not taxable. It only **becomes taxable** when other income causes the total "provisional income" to exceed certain thresholds. It's a multi-step process that can be calculated using the **IRS worksheet**. This structure creates what's known as a "tax torpedo" or a "snowball effect."

If you aren't familiar with the tax torpedo, consider this example:

John is single and has $2,000 per month in pensions and $2,000 per month in Social Security. His tax return shows he is in the 12% bracket. John also has a brokerage account where he usually recognizes about $10,000 of long-term capital gains and qualified dividends per year. This year, he takes an extra $2,000 out of his IRA. Being in the 12% bracket, he expects to pay $240 extra in federal income tax. His tax bill on the extra withdrawal is actually $474, almost double what he expected, because each additional dollar of IRA withdrawal dragged in 85 cents of a Social Security dollar that would otherwise have been tax free. If John takes out another $234 to pay the extra tax, he'll actually lose 49.95% to federal income tax because that withdrawal will not only create additional taxable Social Security benefits, but will also push some capital gain that would have come through at a 0% rate into a 15% capital gains tax rate. Whether you call it a torpedo, a snowball, or something else, the combination of different income types in retirement can create some really ugly distortions in tax rates.

The standard deduction is mostly overlooked in the financial planning literature. The standard deduction allows a certain amount of income to be received tax free. For a married couple filing jointly in 2018, the amount is $24,000, plus an additional $2,600 if both are over 65 years old or blind. Each year, it increases with inflation. Does that mean they can take an IRA withdrawal of $24,000 before tax kicks in? Not in the presence of Social Security. The amount they can withdraw before creating taxable income varies based on Social Security. For example, a couple with $10,000 of Social Security income can take the full $24,000 out of an IRA without making any of their Social Security benefit taxable, but a couple with $80,000 of Social Security benefits can only withdraw about $11,500 from an IRA before losing 18.5 cents of each additional dollar to federal income tax.

If you used the **IRS worksheet** to figure out how much you could withdraw before experiencing any tax impact, you would have to complete it multiple times, increasing the ordinary income amount each time in order to figure out how much you can withdraw in the presence of the Social Security benefit.

I've put together a table (using **Tax Clarity**) to save you time. The first column is the amount of Social Security benefit the client will have for 2018. The second column is how much ordinary income, i.e., IRA withdrawals or Roth conversions the client can have before actually paying any tax at all. The third column is the highest effective marginal rate the client can reach with just IRA withdrawals and Social Security — notice how few actually line up with the brackets? Often, you won't want to exceed the threshold for Column 2 if you can avoid it. The last column is the highest effective marginal rate the client can reach (based solely on ordinary income and Social Security). With lower Social Security benefits, the torpedo doesn't pack as much gunpowder, but with higher benefits, the rate can get pretty steep.

Social Security Benefit	MFJ other ordinary income before tax	EMR on Next Dollar	Highest EMR
$10,000	$24,000	10%	22%
$20,000	$23,250	15%	22%
$30,000	$21,750	15%	22%
$40,000	$20,000	15%	22%
$50,000	$18,250	15%	40.7%
$60,000	$16,000	18.5%	40.7%
$70,000	$13,750	18.5%	40.7%
$80,000	$11,500	18.5%	40.7%

How Can Advisors Add Value?

One of the biggest problems I see with people who retire and use funds from their brokerage accounts or even cash savings for living expenses is that they are often paying no federal income tax at all. They're thrilled, but really, they may be setting themselves up for a big tax impact at 70 ½ when their required minimum distributions begin. At minimum, they should be recognizing enough income to be right at the edge of paying tax.

If they’re not, some small Roth conversions each year until 70 ½ will reduce the RMD, reducing the tax later in life. If the client never uses the Roth money during their lifetime, the funds pass tax-free to their heirs. The table above gives you a very quick reference for the client who has only ordinary income and Social Security benefits to be able to quickly determine whether there is room for conversions prior to commencing RMDs. If the client has capital gains or qualified dividends, the rates get steeper, faster. There can be hidden value when you choose an alternative harvesting pattern.