

Taxation of social security benefits

Dear Client:

How are Social Security benefits taxed? That depends on your other income. In the worst case scenario, 85% of your benefits would be taxed. (This doesn't mean you pay 85% of your benefits back to the government in taxes—merely that you would include 85% of them in your income subject to your regular tax rates.)

To determine how much of your benefits are taxed, you must first determine your other income, including certain items otherwise excluded for tax purposes (for example, tax-exempt interest). Add to that the income of your spouse, if you file jointly. To this add half of the Social Security benefits you and your spouse received during the year. The figure you come up with is your total income plus half of your benefits. Now apply the following rules:

1. If your income plus half your benefits is not above \$32,000 [\$25,000 for single taxpayers], none of your benefits are taxed.
2. If your income plus half your benefits exceeds \$32,000 but is below \$44,000, you will be taxed on (1) one half of the excess over \$32,000, or (2) one half of the benefits, whichever is lower.

Example (1): Sam and Denise have \$20,000 in taxable dividends, \$2,400 of tax-exempt interest, and combined Social Security benefits of \$21,000. Thus, their income plus half their benefits is \$32,900 (\$20,000 plus \$2,400 plus 1/2 of \$21,000). They must include \$450 of the benefits in gross income (1/2 (\$32,900 – \$32,000)). (If their combined Social Security benefits were \$5,000, and their income plus half their benefits were \$40,000, they would include \$2,500 of the benefits in income: 1/2 (\$40,000 – \$32,000) equals \$4,000, but 1/2 the \$5,000 of benefits (\$2,500) is lower, and the lower figure is used.)

[For single taxpayers substitute the following for the above:

2. If your income plus half your benefits exceeds \$25,000 but is below \$34,000, you will be taxed on (1) one half of the excess over \$25,000, or (2) one half of the benefits, whichever is lower.

Example (1A): Sam has \$20,000 in taxable dividends, \$2,400 of tax-exempt interest, and Social Security benefits of \$9,000. Thus, his income plus half his benefits is \$26,900 (\$20,000 plus \$2,400 plus 1/2 of \$9,000). He must include \$950 of the benefits in gross income (1/2 (\$26,900 – \$25,000)). (If his Social Security benefits were \$3,000, and his income plus half his benefits were \$30,000, he would include \$1,500 of the benefits in income: 1/2 (\$30,000 – \$25,000) equals \$2,500, but 1/2 the \$3,000 of benefits (\$1,500) is lower, and the lower figure is used.)]

3. If your income plus half your benefits exceeds \$44,000 [\$34,000 for single taxpayers], the computation in many cases grows far more complex. Generally, however, unless your income plus half your benefits is fairly close to \$44,000 [\$34,000 for single taxpayers], if you fall into this category, 85% of your Social Security benefits will be taxed.

Caution: If you aren't paying tax on your Social Security benefits now because your income is below the above floor, or are paying tax on only 50% of those benefits, an unplanned increase in your income can have a triple tax cost. You'll have to pay tax (of course) on the additional income, you'll also have to pay tax on (or on more of) your Social Security benefits (since the higher your income the more of your Social Security benefits that are taxed), and you may get pushed into a higher marginal tax bracket. This situation might arise, for example, when you receive a large distribution from a retirement plan (such as an IRA) during the year or have large capital gains. Careful planning might be able to avoid this stiff tax result. For example, it may be possible to spread the additional income over more than one year, or liquidate assets other than an IRA account, such as stock showing only a small gain or stock whose gain can be offset by a capital loss on other shares. If you should need a large amount of cash for a specific purpose, please contact me before liquidating any assets, so I can determine just what your additional tax cost will be.

If you know your social security benefits will be taxed, you can voluntarily arrange to have the tax withheld from the payments by filing a Form W-4V. Otherwise, you may have to make estimated tax payments.

If you'd like us to run some specific numbers for you, or if you would like to discuss this matter further, please call us at 978-854-5656.

Very truly yours,

Neal A. Price & Company, LLP

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