

When Social Security Is Taxed

Here's how to know whether your benefits are taxable.

Are Social Security benefits taxable?

Kevin responds:

Most Social Security benefits are tax free, but for some taxpayers, 85% of their benefits are taxable. Here's a discussion from my book, *Cut Your Taxes*, that explains how it works:

Congress seems determined to make this issue more and more complicated. Not so long ago, the tax rules for social security benefits were the epitome of simplicity: Benefits were tax-free. Period. Now beneficiaries fall into one of three categories:

1. Those whose benefits remain totally tax-free.
2. Those who can have up to 50% of their benefits taxed.
3. Those who can have up to 85% of their benefits taxed.

If you're among the 10 million or so retirees whose benefits are hit, you need to know the rules.

The first step in determining whether or not your benefits are vulnerable is to find your "provisional income." That's basically your adjusted gross income plus any tax-exempt interest plus 50% of your social security benefits.

Your benefits are totally tax free if your provisional income is less than \$25,000 if you file a single or head-of-household return or less than \$32,000 if you file a joint return. (Unlike many other thresholds in the tax law, these figures are not indexed to rise with inflation. And, that's not an oversight. Congress did it deliberately so that, over time, more and more beneficiaries would be subject to this tax.)

If your provisional income exceeds the threshold for your filing status, what portion of your benefits can be taxed depends on how high your income is.

If it is between \$25,000 and \$34,000 on a single or head-of-household return or between \$32,000 and \$44,000 on a joint return no more than half of your benefits can be taxed. The amount included in taxable income is the lesser of half of your benefits or half of the amount by which provisional income exceeds the trigger point.

Assume you and your spouse file a joint return. Your AGI for the year is \$30,000, and you have an extra \$4,000 of tax-free interest from municipal bonds and \$5,000 of social security benefits. Adding your AGI (\$30,000), your tax-exempt interest (\$4,000) and half of your benefits (\$2,500) gives you \$36,500. That's \$4,500 over the \$32,000 threshold for joint returns. Since half of that amount (\$2,250) is less than half your benefits (\$2,500), the smaller amount is the part of your social

security that is taxed. In the 28% bracket, the extra \$2,250 of taxable income will cost \$630.

The 85% rule. When provisional income exceeds \$34,000 on a single return or \$44,000 on a joint return, things get more complicated, but the bottom line is this: In almost all cases, 85% of your benefits are taxed. The IRS has devised an 18-line worksheet for figuring how much of your benefits are taxable. You'll find it in the instructions for your tax return.

What about married couples who file separate returns? They can forget the \$25,000/\$32,000 and the \$34,000/\$44,000 thresholds. Their threshold is \$0 -- and they can be certain that 85% of their social security benefits are taxable.

Strategies. If part of your benefits are threatened, some planning can help limit the bite. If your AGI will include amounts withdrawn from a regular IRA, for example, you may be able to stagger your withdrawals and vary your income so that your social security benefits are taxed only in alternate years. An advantage of the new [Roth IRA](#) is that, since qualified withdrawals are tax-free, that money can't push more of your social security benefits into the taxable range.

Timing the sale of stocks or other appreciated property can also pay off. You could take profits in years when 85% of your benefits will be taxed anyway, for example, and limit income in intervening years to reduce the amount of your social security that falls prey to the IRS.

If you have municipal bonds, you may consider unloading them since this "tax-free" income can trigger a tax on your social security benefits. That could backfire, however, because switching to a comparable taxable investment would probably give you a higher yield that could push even more of your benefits into the taxable range. Even though tax-exempt income is taken into account in the social security formula, the income itself is still not taxed.