Calculating After-Tax Social Security Benefits

By Kerry Pechter *Thu, Dec 15, 2016*

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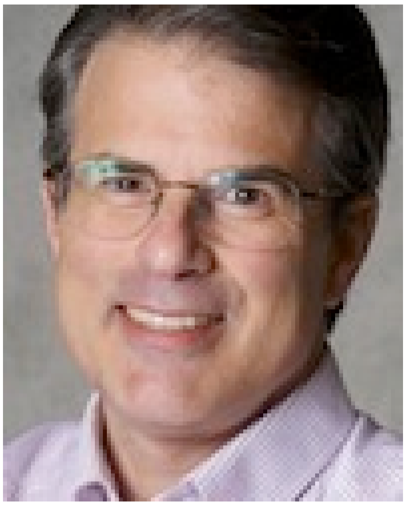

A healthy 75-year-old I know has few if any financial worries. He is a partner in a successful plastics factory. He owns a share in a ranch out West. He even has a climate-controlled garage full of new and vintage sports cars.

His main issue, of course, is taxes. He recently complained about how much tax he pays on his Social Security benefits. "There's almost no benefit left," he said. But he said it with a dry smile. He knows that the OASDI system wasn't designed with him in mind.

Yes, many people, including perhaps most of your clients, will earn enough in retirement to owe taxes on as much as 85% of their Social Security benefits.

How much will they pay? A handy crib-**sheet** recently published by Vanguard shows the formulae for calculating the portion of an individual's or couple's Social Security benefits that will be subject to ordinary income tax.

The first step is to calculate the client's Provisional Income. This is the sum of the client's Adjusted Gross Income (including realized capital gains), plus the interest they receive from tax-exempt bonds, plus one-half of their Social Security benefit.

Depending on the level of Provisional Income (and depending on whether the client is single, a married couple filing jointly, or a couple filing separately), as little as 0% or as much as 85% of the Social Security benefit will be subject to federal income tax. If a couple's PI exceeds $44,000, then up to 85% of the Social Security benefit will be taxable (See table below).

The exact percentage of Social Security income that's taxable, according to Vanguard, is the *smallest* of the following three calculations:

1. 85% of Social Security benefits.
2. 50% of Social Security benefits + 85% of Provisional Income over $34,000 (for singles)

or $44,000 (for couples filing jointly).

3. 50% of PI over $25,000 (single) or $32,000 (married, filing jointly) + 35% of PI over $34,000 (single) or $44,000 (married, filing jointly).

For example, consider a couple with $40,000 in AGI from part-time income, capital gains, and Required Minimum Distributions, $20,000 in interest from municipal bonds and $28,000 in Social Security benefits, after deductions and exemptions. The Provisional Income would be $74,000. How much of their benefits would be taxed?

- Under Calculation 1 above, 85% of the Social Security benefit or $23,800 would be taxable.
- Under Calculation 2, ($25,500 + $14,000) $39,500 would be taxed.
- Under Calculation 3, ($21,000 + $10,500) $31,500 would be taxed.

So, in this case, $23,800 of their Social Security benefit would be taxed. The couple's taxable income would be $23,800 + $40,000 = $63,800. Given the current tax brackets, they would owe $6,787, or 15% of the amount over $18,550 ($45,250). (In this case, the tax on their capital gains and ordinary income would both be 15%). Of that $6,787, roughly 40% or $2,720 could be thought of as a reduction in their Social Security benefits. (We're excluding the impact of Medicare-related deductions or taxes.)

So, even without legislating any changes in the calculation of Social Security benefits, the federal government, by the way it taxes those benefits, already claws back part of the payout and, in effect, makes the system marginally more progressive.