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Retirees, Beware These Tax Traps on Social Security and Medicare

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Susan Brickman's monthly Medicare premiums jumped almost 70% this year, to $559, after the widow of two years found herself in a higher tax bracket as a single taxpayer.

"I felt offended that it happened," says the 72-year-old Brickman, who lives in Charlottesville, Va. "I also feel, and this is crazy, 'Why am I being punished for being a widow?' "

Medicare has a series of income limits that trigger increasingly higher payments for retirees. And it's not just the rich who are affected. Brickman's 2018 modified adjusted gross income of $163,414—derived from a combination of required minimum distributions, Social Security, and her husband's pensions—was just enough to put her in the second-highest Medicare bracket (which begins at $163,000) and drive up her premium this year.

Retirees face multiple income traps like the one Brickman fell into. Lower- and middle-income retirees get hit by the so-called tax torpedo, as rising income causes their Social Security benefits to be taxed. The result is marginal tax rates as high as 40.7%. There is also a Medicare surtax of 0.9% on couples with taxable income topping $250,000, and capital-gains taxes increase as incomes rise, among others.

While it's too late to make many changes for this tax-filing season, extended three months to July 15 because of the pandemic, seniors can take steps to avoid or minimize tax traps. These include delaying spending from one year to the next and judiciously tapping after-tax accounts to lower taxable income.

"It really hurts when you cross over from one threshold to the next, and you say, 'If I just hadn't sold that stock position, or taken that money out of my IRA, I wouldn't have to pay that surcharge,' " says Josh Trubow, a financial advisor in suburban Boston.

One tax trap won't be much of a concern for some retirees next year: required minimum distributions. While many retirees get forced into tax traps because of large RMDs from 401(k)s, traditional individual retirement accounts, and other tax-deferred accounts, the emergency legislation passed in response to the coronavirus crisis eliminated RMDs for this year, which will help many retirees avoid tax torpedoes when they file their 2020 taxes next year.

However, RMDs will be back when filing 2021 taxes, and it would pay to start thinking about avoiding future RMD-induced tax torpedoes now. RMDs used to begin at age 70½, but after last year's passage of the Secure Act, they now begin at 72.

To avoid getting pushed into a higher tax bracket, Andrew Feldman, a Chicago financial advisor, frequently counsels high-income clients to take their RMDs as a qualified charitable distribution if they don't need the income. That way, it won't trigger higher taxes or higher future Medicare premiums. To do so, retirees must direct the administrator of their tax-deferred account to make a donation directly to the charity.

For the greatest tax efficiency, however, seniors should be taking steps long before tax torpedoes or Medicare income limits hit. Retirees in their 60s often pay little or no taxes before they begin taking Social Security. Many are living off after-tax savings, Roth IRA accounts, or inherited money. The standard advice is to spend this money before tapping tax-deferred accounts. Then, they can take advantage of their low tax bracket to convert money in tax-deferred accounts to Roth IRAs. It's also advantageous to sell winning positions and take capital gains while in a low tax bracket.

"That's the optimal time to think about Roth conversions," says Roger Young, a senior financial planner at T. Rowe Price. "Because you might be in a lower tax bracket than you will be later."

The Social Security tax torpedo can hit hard. Rick Winter, a 79-year-old Maine retiree who has income of about $82,000 a year, learned that a year ago when he prepared to take $4,000 out of a tax-deferred account for a vacation with his wife, Mary Helen Williams. Their normal top tax bracket was 12%. But they had hit the income limits for avoiding Social Security taxes. That meant that $4,000 in additional income would cause $3,400 in Social Security income to be taxed, as well. The result was that his marginal tax rate would be 22.2% instead of 12%.

That irked Winter. "It's the principle of the thing," says Winter, a retired university worker. "We're not wealthy by any means. For people in our tax bracket, it's pretty unfair."

Working with their financial advisor, Jim Bradley, the couple instead withdrew $3,000 from their Roth IRA and sold off a $1,000 stock position in which they had little capital gain to dodge the tax torpedo. "They avoided an $888 tax on their vacation," says Bradley, founder and chief investment officer at Penobscot Financial Advisors.

Retirees earning more than Winter face an even bigger torpedo. Those in the 22% income tax bracket would see their marginal tax rate jump to 40.7%, as rising income causes 85% of their Social Security benefits to be taxed.

The tax torpedo applies only to a certain range of income. Hardest hit are retirees who derive a big portion of their income from Social Security, such as a couple where each spouse is getting big monthly benefits. A couple receiving $65,000 in Social Security benefits this year will pay the 40.7% tax rate on other income ranging from $60,230 to $69,441, says William Reichenstein, a Baylor University finance professor emeritus who is head of research at Retiree Inc.

"What happens is that each dollar of income in that bracket causes another 85 cents of Social Security to be taxed," he says.

Higher-income retirees usually aren't affected by the tax torpedo. They probably already are paying taxes on 85% of their Social Security benefits, the maximum set by law.

Part B Premiums

If your modified adjusted gross income as reported on your tax return from two years ago is above a certain amount, you'll pay the standard premium and an Income Related Monthly Adjustment Amount.

Single Filer	Married Filing jointly	Married Filing Separate	Monthly Charge (in 2020)
$87,000 or less	$174,000 or less	$87,000 or less	$144.60
above $87,000 up to $109,000	above $174,000 up to $218,000	N/A	202.40
above $109,000 up to $136,000	above $218,000 up to $272,000	N/A	289.20
above $136,000 up to $163,000	above $272,000 up to $326,000	N/A	376.00
above $163,000 and less than $500,000	above $326,000 and less than $750,000	above $87,000 and less than $413,000	462.70
$500,000 or above	$750,000 and above	$413,000 and above	491.60

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Centers for Medicare & Medicaid Services

Then there are the income limits for Medicare premiums. The premiums are based on the income and filing status of retirees two years earlier. Couples who had a measure of income under $174,000 in 2018 or single taxpayers under $87,000 a year pay the basic Medicare premium this year of $144.60 a month. Above that are five different income limits, each triggering higher premiums. A married couple topping $750,000 will pay an extra $8,328 in Medicare premiums between them per year on top of the $3,470 they are paying for the base Medicare premium. They will also pay an extra $1,834 for their Part D drug coverage.

The good news is that a single year of high income will push up Medicare premiums only for a year. So if your income is rising for a one-time event—like capital gains from the sale of a business or home—your Medicare premium will fall back to its normal level after your income does.

In addition, retirees can petition for relief from higher premiums because of life-changing events such as the death of a spouse. That’s what Brickman, the Charlottesville retiree, ended up doing.

Brickman had always relied on her husband, Bob, a retired cardiac surgeon and lawyer, to handle the family finances. When he died in late 2017 of congestive heart failure, she kept taking the same RMDs from her late husband’s nearly $2 million tax-deferred account, as he had taken. But Brickman was 11 years younger than her husband, and RMDs rise with age. “I had no idea what I was required to do as far as his IRA was concerned,” she says.

Last year, her financial advisor, Barbara Ristow of Buckingham Strategic Wealth, informed Brickman that she could take out less money from her husband's tax-deferred account and still satisfy government distribution requirements.

Brickman says her initial thought after receiving the government letter in November warning of the coming Medicare premium bump was that there was little she could do about it. "It was just something I had to live with."

Then she decided she had nothing to lose by filing by an appeal. So, in early January, Brickman filed a form for life-changing events, asking that her Medicare premiums be based on her lower estimated 2019 modified adjusted gross income rather than the $163,414 in 2018. She predicts her income will fall further in 2020. She marched into her local Social Security office and handed it to an official. He warned her an appeal might take six weeks.

It didn't. A few days later, the government temporarily lowered her monthly payment. The drop was slated to become permanent after Brickman filed her taxes and showed the government her actual income for last year.

"It was quite a simple process," says Brickman. She adds, "My experience with the Social Security office has not been as onerous as I expected."