

# THE SOCIAL SECURITY TAX SURPRISE

BY LLOYD LOFTON



Today someone in America is retiring. In fact, starting this year some 10,000 individuals a day are retiring. Those in the boomer generation are now making decisions that will have a lasting impact on this next phase of their lives. These individuals will have a higher income than their parents did, and for the most part, they will have a higher education level.

According to the Social Security Administration, they will have an average number of years in retirement of 17.89 (19.2 years for females and 16.3 for males). When they retire, two things will happen: They will apply for Social Security and upon doing so will be enrolled in Medicare.

Signing up for Social Security is the last step in a relationship with our federal government that these retiring individuals have been involved in their entire working lives. Each pay period, these individuals had money taken out of their paychecks that they believed would play a large part in their retirement income. When they complete this step, many may experience “The Social Security Surprise” as they see part of their Social Security check being taxed.

## Social Security History

In 1935, President Roosevelt signed into law one of the most significant pieces of legislation of our time—the Social Security Act. At the time, the U.S. Treasury ruled that benefit payments were gifts and would not be subject to tax.

In 1983, Congress changed the law and allowed up to 50 percent of Social Security benefits to be subject to tax. In 1993, the law was changed again—now up to 85 percent may be taxed. So what causes Social Security to be taxed? The taxation is based on the amount of income received in a calendar year. This is called “provisional income.”

## Provisional Income – Married

For married or head of household:

- Social Security can become taxable when income plus half of the amount received from Social Security exceeds \$32,000—up to 50 percent of Social Security benefits.
- If the amount exceeds \$44,000, up to 85 percent of Social Security benefits can be taxed.

## Provisional Income – Single

For a single person:

- Social Security can become taxable if income plus half of the amount received from Social Security exceeds \$25,000—up to 50 percent of Social Security benefits.
- If the amount exceeds \$34,000, up to 85 percent of Social Security benefits can be taxed.

## What is Provisional Income?

Income from these accounts may be the reason your clients pay more taxes, including the tax on their Social Security:

1. IRA distributions
2. Certificates of deposit
3. Money market accounts
4. U.S. Treasury bills
5. Mortgage certificates
6. Capital gains
7. Dividends
8. Tax-free bonds
9. Corporate bonds
10. Half of Social Security

Income from any combination of these accounts added to half of Social Security

results in a “threshold income” that determines the tax that may have to be paid.

## What is the Average Monthly Benefit for Retired Workers?

As of June 30, 2010, the average monthly benefit for couples in which both are receiving benefits is \$1,900. This is \$22,800 per year for a retired couple at the average benefit level. For single recipients, the average monthly benefit is \$1,158—or \$13,896 annually.

Table 1 shows income levels at which Social Security would be fully exempt. This is subject to inclusion in taxable income at the 50 percent rate and at the 85 percent rate. An example is listed below for a couple and single retiree with an average level of benefits. Total income refers to the combination of taxable source income and Social Security.

The table shows that a married couple receiving the average Social Security benefit of \$22,800 and total income from all sources of less than \$43,400 is not subject to tax on any Social Security benefits. A couple with average benefits and total income over \$71,141 must include 85 percent of the Social Security, or \$19,380 in taxable income. Social Security income included in taxable income is taxed at the same rate as other kinds of income—5.35 percent, 7.05 percent, or 7.85 percent, depending on the total amount of taxable income.

When income is deferred instead of taxed, it reduces provisional income and may lower amounts below the allowed thresholds.

Individuals planning retirement may want to evaluate their current risk tolerance to see where their finances would fit best.

They may find that a CD is a conservative investment but not be happy with the low interest rate. They might like the potential return on stocks but not the threat to principal.

But you can ask them, “If you could participate in growing your principal and provide the protection from the risk of stocks, you would be interested, right? You may be able to do this by repositioning the assets that have created a tax on your Social Security.”

**Section 72**

Section 72 of the Internal Revenue Code allows “income credited on a deferred annuity contract is not currently includable as income.” Based on Section 72, income credited inside an annuity may not create a tax on Social Security.

Let’s look at two examples (Table 2) of how Section 72 could have an effect on someone’s Social Security income.

By repositioning Gary and Lisa’s 1099 assets (that created taxable income) into a deferred annuity, the tax of \$1,913 on their Social Security was eliminated.

Gary and Lisa did not withdraw the \$20,000 taxable interest they earned from their 1099 assets; rather, they had the earnings roll back into the assets. They were forced into taking money from their monthly retirement checks to pay the tax on this 1099 income that they did not access.

Interest earned within a deferred annuity (and not withdrawn) may eliminate or reduce the income tax on Social Security and could increase net retirement income. And in many cases retirees can access up to 10 percent of their funds each year without a penalty, depending on policy provisions.

Today someone in America is retiring. The lasting impact of retirement planning on this next phase of their lives could be ensuring that things that have become staples in their lives remain staples and not luxuries—visiting grandkids, traveling, getting the brands of medication they feel comfortable with, and shopping at their favorite grocery stores for their comfort foods. “The Social Security Surprise” may be that retirement is just as they imagined it would be—safe and secure. [LNN](#)

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**TABLE 1**  
TAXATION OF SOCIAL SECURITY BENEFITS, TAX YEAR 2011

	RETIRED MARRIED COUPLE Annual Social Security income: \$22,800	RETIRED SINGLE WORKER Annual Social Security income: \$13,896
<b>Social Security exempt</b>	Total income less than \$43,400	Total income less than \$31,948
<b>Social Security included in taxable income at 50% rate</b>	Total income between \$43,400 and \$55,400	Total income between \$31,948 and \$40,948
<b>Social Security included in taxable income at 85% rate</b>	Total income between \$55,400 and \$71,141	Total income between \$40,948 and \$49,550
<b>Social Security subject to full 85% inclusion in taxable income</b>	Total income over \$71,141	Total income over \$49,550

**TABLE 2**  
IRS SECTION 72 EFFECT ON SOCIAL SECURITY INCOME

**Single – Example:** Sam is retired and living comfortably. He receives a pension and Social Security. His savings are in CDs, mortgage certificates, and money market accounts. He doesn’t need the interest, so he reinvests the interest back into his certificates.

**SAM’S INCOME**

Pension	\$19,200
Social Security	\$11,400
CDs, Mortgage Certificates	\$12,400
Money Market	\$4,400
Total Income Received	\$47,400

**SAM’S TAX ON SOCIAL SECURITY**

Social Security	\$11,400
Social Security (subject to tax)	\$9,690
<b>Tax on Social Security</b>	<b>*\$2,665</b>

*\* Estimated based on tax table*

**Total Federal Income Taxes \*\$6,828**  
*\* Estimated Income Tax*

*An annuity may have eliminated or reduced the tax on Sam’s Social Security income...*

**SAM’S SOCIAL SECURITY THRESHOLD**

Pension	\$19,200
1/2 Social Security	\$5,700
CDs, Mortgage Certificates	\$12,400
Money Market	\$4,400
Threshold Income	\$41,700
Threshold Limit	\$25,000

Sam’s Income	w/Annuity	Without
Total Threshold Income	\$41,700	\$41,700
Annuity (Deferred Interest)*	(\$16,800)	\$0
Threshold Income	\$24,900	\$41,700
Threshold Limit (single)	\$25,000	\$25,000
Over or Below Threshold	Below	Over
Social Security Taxed	\$0	\$9,690
Tax on Social Security	\$0	\$2,665

**Over Threshold \$16,800**

*Triggered a tax on Sam’s Social Security!*

**Federal Tax Due \$1,598** vs **\$6,828**  
*\*Assumes the interest paid by the annuity is the same as paid by the certificates of deposit and money market accounts.*

**Married – Example:** Gary and Lisa are retired and spend time in a winter home. Gary and Lisa receive a pension and a distribution from an IRA. They also receive 1099 income and Social Security. They don’t need the 1099 income, so they reinvest the interest.

**GARY & LISA’S INCOME**

Pension/IRA Distribution	\$24,450
1099 Income	\$20,000
Social Security	\$15,000

*There May Be a Different Way...*

Gary & Lisa’s Income	w/Annuity	Without
Total Threshold Income	\$59,450	\$59,450
Annuity (Deferred Interest)	(\$20,000)	\$0
Threshold Income	\$39,450	\$59,450
Threshold Limit (married)	\$44,000	\$44,000
Over or Below Threshold	Below	Over
Social Security Taxed	\$0	\$12,750*
Tax on Social Security	\$0	\$1,913

**TAX ON SOCIAL SECURITY**

Social Security	\$15,000
85% subject to tax	\$12,730
<b>Tax on Social Security</b>	<b>\$1,913*</b>

*\* Estimated based on tax table @ 15 percent*

**TAX ON GARY & LISA’S REMAINING INCOME**

Pension/IRA Income	\$24,450
1099 Income	\$20,000

**Federal Tax Due \$555.00\*** vs **\$3,073\***  
*\*Assumes earnings from an annuity are not withdrawn but are left to accumulate. Assumes standard deductions.*

**Tax on Remaining Income \$3,073\***  
*\* Estimated based on tax table @ 15 percent*