

Taxable Social Security Benefits and High Marginal Tax Rates

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ABSTRACT

When Social Security Benefits (SSBs) are collected, the usual federal tax rates of 0 percent, 10 percent, 15 percent, 25 percent, 28 percent, 33 percent, 35 percent, and 39.6 percent change to effective marginal tax rates (MTRs) of 0 percent, *15 percent*, *22.5 percent*, *27.75 percent*, *46.25 percent*, 25 percent, 28 percent, 33 percent, 35 percent, and 39.6 percent. The four higher effective MTRs (italicized) are due to SSBs phasing in as taxable until reaching the maximum taxable percentage, 85 percent. Further, if the taxpayer's income contains any qualified dividends or long-term capital gains, an effective MTR of 55.5 percent is sandwiched between the 27.75 percent and 46.25 percent MTRs. This article identifies when a client has a higher effective MTR and discusses tax planning strategies.

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Regardless of filing status (e.g., single, married filing jointly, head of household), under 2017 federal income tax law, the statutory tax rate (STR) brackets are progressive, climbing in the following order as ordinary taxable income increases: 0 percent, 10 percent, 15 percent, 25 percent, 28 percent, 33 percent, 35 percent, and 39.6 percent. The 0 percent rate bracket effectively arises from the combination of the taxpayer's exemption deduction(s) of \$4,050 per exemption and the greater of the standard deduction or itemized deductions, the former of which is \$6,350 for a taxpayer filing as single and under age 65 and \$12,700 for married taxpayers filing a joint tax return where both are under age 65. (The exemption and standard deductions are indexed for inflation annually.) When a client collecting Social Security benefits (SSBs) has income low enough that none of the SSBs is taxable (i.e., \$0 of the SSBs is included in gross income), the client's effective marginal tax rate (MTR) (i.e., additional tax on the next \$1 of ordinary income) is the same as the client's STR bracket. When a client collecting SSBs has income high enough that the maximum amount of SSBs is taxable (i.e., 85 percent of SSBs), again the client's effective MTR is the same as the client's STR bracket. In contrast, when greater than 0 percent and less than 85 percent of SSBs are taxable, the client's effective MTR is significantly higher than the client's STR bracket [i.e., *15 percent* instead of 10 percent, *22.5 percent* or *27.75 percent* instead of 15

percent, and *55.5 percent* (possibly) or *46.25 percent* instead of 25 percent]. Such cases (i.e., when the effective MTR is higher than the corresponding STR bracket) have been dubbed the Social Security “tax torpedo.”¹ Taxpayers with relatively low levels of SSBs might not have all of these higher effective MTRs apply to them.²

Ordinary STR Brackets

Every tax is a base multiplied by a rate (i.e., a percentage). The base for the federal income tax, called taxable income (TI), is, simply put, what has to be included in income minus allowable deductions. Two partial (i.e., the 28 percent, 33 percent, 35 percent, and 39.6 percent rates are not listed) individual federal tax rate schedules for 2017 are shown in Tables 1 and 2.³

These rates in these two federal STR schedules are also referred to by tax practitioners as ordinary tax rate brackets because they apply to ordinary income [i.e., not to qualified dividend (QD) and long-term capital gain income]. In the Examples section later in this article, additional income places the individual taxpayer’s TI in the 25 percent ordinary tax rate bracket because that is where the very high effective MTRs (i.e., 55.5 percent and 46.25 percent) occur for a taxpayer with taxable SSBs.⁴

Social Security Taxability Phasein and MTRs

Assume a taxpayer has no QD or long-term capital gains (LTCG) income and is in the Social Security exclusion phaseout range (i.e., the range where SSBs phase in as taxable). The federal STRs show that rates on ordinary income increase as TI increases in the following order: 0 percent, 10 percent, 15 percent, 25 percent, and so on. Geisler and Hulse show a single taxpayer collecting SSBs has effective MTR brackets for 2017 changing as ordinary income increases in the following order: 0 percent, *15 percent* [i.e., 10% + (50% × 10%)], *22.5 percent* [i.e., 15% + (50% × 15%)], *27.75 percent* [i.e., 15% + (85% × 15%)], *46.25 percent* [i.e., 25% + (85% × 25%)], 25 percent (followed by 28 percent, 33 percent, 35 percent, and 39.6 percent).⁵ Note that the second through the fifth rates (italicized) do not correspond with the ordinary STRs

because the taxability of SSBs is phasing in at either a 50 percent or an 85 percent rate. For example, the 46.25 percent MTR bracket stems from the SSBs’ phasein at an 85 percent rate and TI being in the 25 percent STR bracket. In such case, assuming no QD or LTCG income, an additional \$2,000 of ordinary income thus will increase taxes by \$925: \$500 of tax on the income *per se*, and \$425 (i.e., 85% × \$2,000 × 25%) of tax on the additional SSBs that the additional income causes to be taxed. In other words, an additional \$2,000 of ordinary income increases the amount of SSBs included in income by \$1,700, and the combined increase in income of \$3,700 taxed at the 25 percent STR equals \$925 more tax, so the effective MTR is 46.25 percent (i.e., \$925 / \$2,000). At the point where exactly 85 percent of SSBs become income, the in-

TABLE 1
Partial Ordinary Income Tax Rate Schedule:
Single Filing Status

If TI is over:	But not over:	The tax is:
\$0	\$9,325	10% of TI
\$9,325	\$37,950	\$933 plus 15% of the amount over \$9,325
\$37,950	\$91,900	\$5,226 plus 25% of the amount over \$37,950

TABLE 2
Partial Ordinary Income Tax Rate Schedule:
Married Filing Jointly Status

If TI is over:	But not over:	The tax is:
\$0	\$18,650	10% of TI
\$18,650	\$75,900	\$1,865 plus 15% of the amount over \$18,650
\$75,900	\$153,100	\$10,453 plus 25% of the amount over \$75,900

dividual's effective MTR drops significantly, from 46.25 percent back to the STR of 25 percent.

Background: SSBs and the Phasein of Their Taxability

Geisler and Hulse summarize the taxability of SSBs. The following is a brief restatement. The amount of SSBs that are taxable depends on provisional income (PI). PI is generally a taxpayer's modified adjusted gross income [AGI, which is the amount on line 37—the bottom of the first page of Form 1040—but it is increased (i.e., modified) by not allowing certain exclusions from income including foreign earned income and not allowing certain deductions allowed for computing AGI, including interest paid on higher education loans] + tax-exempt (i.e., municipal bond) interest (the amount on line 8b of Form 1040) + half of SSBs (SSBs is the amount on line 20a of Form 1040). Some of the taxpayer's SSBs become taxable when PI exceeds \$25,000, if single, and for married filing jointly taxpayers when PI exceeds \$32,000. The 50 percent phasein ends for a single taxpayer when PI reaches \$34,000 and for married filing jointly taxpayers when PI reaches \$44,000. So if taxable SSBs (the amount on line 20b of Form 1040) exceeds \$4,500 (i.e., half of the range from \$25,000 to \$34,000) for a single taxpayer or exceeds \$6,000 (i.e., half of the range from \$32,000 to \$44,000) for married filing jointly taxpayers, the phasein of the last dollar of SSBs thus occurs at an 85 percent rate.⁶

The SSBs taxability phasein is not indexed for inflation. The first tier (causing up to 50 percent of SSBs

to be included in income) of this phasein came into the law in 1983. The second tier (causing up to 85 percent of SSBs to be included in income) of this phasein came into the law in 1993. Other things being equal, except assuming SSBs increase from one year to the next due to an inflation adjustment, an individual with some taxable SSBs in the first year (but less than the maximum of 85 percent) will have an increasing percentage of the individual's SSBs be taxable in the following year. Ultimately, if PI raises enough, the maximum, 85 percent of SSBs, will become taxable and, other things equal, it will stay that way in all future years. When taxable SSBs equal 85 percent (i.e., when line 20b divided by line 20a of Form 1040 equals 85 percent), the effective MTR is no longer higher than the STR bracket, and the taxpayer's TI (line 43 of Form 1040) places the taxpayer in the 25 percent, 28 percent, 33 percent, 35 percent, or 39.6 percent ordinary tax rate bracket.

QD and LTCG Income STRs

Assume that some of an individual taxpayer's income is QD and/or LTCG. The way the rates are applied in the law is that the amount of QD and LTCG is assumed to be the last (i.e., the top) portion of TI. The tax rate schedule for the QD and LTCG portion of TI that is taxed at a lower rate for 2017 is shown in Table 3 for the three lowest ordinary tax rates for both single and married filing jointly statuses.

So far it appears that the lower rate on QD and LTCG is always good news. Surprisingly, nothing could be further from the truth once SSBs become taxable and the taxpayer moves from the 15 percent to the 25 percent ordinary tax rate bracket, as will be shown shortly.⁷

LTCG and/or QD Income

The effect of having QD and/or LTCG income is to insert a 55.5 percent effective MTR bracket in between the 27.75 percent and 46.25 percent effective MTRs for a taxpayer collecting SSBs. The following is an example of when the 55.5 percent effective MTR occurs: Assume a single taxpayer has the following sources of income for 2017: \$10,000 of QD and LTCG

TABLE 3
Partial Qualified Dividend and Long-Term
Capital Gain Income Tax Rate Schedule

If ordinary rate on TI would be equal to	Rate on QD and LTCG income in TI equals
10.0%	0%
15.0%	0%
25.0%	15.0%

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income; \$23,270 of taxable 401(k), 403(b), 457, IRA, and pension distributions [hereafter, for brevity, 401(k) and IRA]; and \$30,000 of SSBs, of which \$16,630 is included in gross income (i.e., taxable). Note that this is less than 85 percent of total SSBs. The fact that \$16,630 of SSBs is taxable is determined as follows: $PI = \$48,270$ [i.e., $\$10,000 + \$23,270 + (\frac{1}{2} \times \$30,000)$]. The first \$25,000 of PI does not cause any SSBs to be taxable; from \$25,000 to \$34,000 of PI causes \$4,500 (i.e., 50 percent of the \$9,000 range) of SSBs to be taxable; from \$34,000 to \$48,270 of PI causes \$12,130 (i.e., 85 percent of the \$14,270 range) of SSBs to be taxable; thus, \$16,630 (i.e., $\$4,500 + \$12,130$) of the \$30,000 of SSBs is taxable. Summing these amounts of income (i.e., $\$10,000 + \$23,270 + \$16,630$) results in total income

and adjusted gross income both equaling \$49,900. After subtracting the standard deduction of \$7,900 for someone single (\$6,350) and aged 65 or over (\$1,550) plus the personal exemption deduction of \$4,050, TI equals \$37,950, the top of both the 15 percent STR bracket and 27.75 percent effective MTR bracket. (See Table 1). The next \$1,000 of ordinary income, such as a \$1,000 distribution from a 401(k) or IRA, will push the individual into the 25 percent STR bracket. However, a couple of interesting things happen in the computation of the additional tax. First, the additional \$1,000 of income is included in the first portion of TI, so it is taxed at 15 percent (instead of 25 percent because more than \$1,850 of income is QD and LTCG, which is treated as the last portion of TI taxed), and so that is \$150 of addi-

TABLE 4

Single Taxpayer in 2017 at Top of 15 Percent STR Bracket (i.e., Top of 27.75 Percent Effective MTR Bracket) with \$1,000 of Additional Ordinary Income

	Before Additional Income	After Additional Income
Additional \$1,000 of ordinary income	N/A	\$1,000
Income	\$49,900	\$51,750 ^a
Sum of standard and exemption deductions	-\$11,950	-\$11,950
TI	<u>\$37,950</u>	<u>\$39,800</u>
Amount of income that is LTCG and/or QD	<u>\$10,000</u>	<u>\$10,000</u>
Amount of TI that is not LTCG and/or QD	<u>\$27,950</u>	<u>\$29,800</u>
Tax on LTCG and/or QD in 15% ordinary tax rate bracket taxed at 0%	$\$10,000 \times 0\% =$ \$0	$\$8,150 \times 0\% =$ \$0
LTCG and/or QD in 25% ordinary tax rate bracket taxed at 15%	$\$0 \times 15\% =$ \$0	$\$1,850 \times 15\% =$ <u>\$278</u>
Tax on LTCG and/or QD	<u>\$0</u>	<u>\$278</u>
10% tax rate on first \$9,325 of TI that is not LTCG and/or QD	\$933	\$933
15% tax rate on TI that is not LTCG and/or QD	$\$27,950 - \$9,325 =$ $\$18,625 \times 15\% =$ <u>\$2,794</u>	$\$29,800 - \$9,325 =$ $\$20,475 \times 15\% =$ <u>\$3,071</u>
Tax on TI that is not LTCG and/or QD	<u>\$3,727</u>	<u>\$4,004</u>
Total tax ^b	<u>\$3,727</u>	<u>\$4,282</u>
Increase in tax		<u>\$555</u>
MTR (additional tax / additional income) (i.e., $\$555 / \$1,000$)		<u>55.5%</u>

Notes:

^a Income is \$1,850 higher—\$1,000 from additional ordinary income, which causes \$850 more in SSBs (\$17,480 of \$30,000 total SSBs is now taxable instead of \$16,630) to become income.

^b The federal tax rate schedule is used to compute tax instead of federal tax table.

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tional tax on the income *per se*, and \$127.50 (i.e., $85\% \times \$1,000 \times 15\%$) of additional tax on the additional SSBs the additional income causes to be taxed. Second, since the QD and LTCG income (\$10,000) is considered by the tax law as the last portion of TI, \$1,850 of such income moves from the 15 percent STR bracket, where it was taxed at 0 percent, to the 25 percent STR bracket, where it will also be taxed at 15 percent. (See Table 3.) This triggers an additional \$277.50 (i.e., $\$1,850 \times 15\%$) in tax. In summary, \$555 of additional federal income tax is paid on \$1,000 of additional ordinary income.⁸ All of this information is summarized in Table 4.

Examples

Financial professionals sometimes have the opportunity to help their clients avoid this common but

infuriatingly high effective MTR. If all of the income is uncontrollable, then a financial professional might not be able to assist a client in avoiding very high effective MTR brackets. On the other hand, to the extent some of the income is controllable, which will be discussed in more detail later, then an excellent tax planning opportunity exists. The key to avoiding the 55.5 percent effective MTR in Table 4 is to not make the additional \$1,000 distribution from the 401(k) or IRA and instead withdraw or sell from an investment that does not trigger income [e.g., Roth retirement account, health savings account (HSA), or taxable account that does not result in a gain]. These avoidance strategies will be discussed more later.

An important issue is to determine how long this 55.5 percent effective MTR bracket lasts (i.e.,

TABLE 5
Single Taxpayer in 2017 with 55.5 Percent Effective MTR

	Before Additional Income	After Additional Income
Additional \$5,405 of ordinary income	N/A	\$5,405
Income	\$49,900	\$59,900 ^a
Sum of standard and exemption deductions	-\$11,950	-\$11,950
TI	<u>\$37,950</u>	<u>\$47,950</u>
Amount of income that is LTCG and/or QD	\$10,000	\$10,000
Amount of TI that is not LTCG and/or QD	<u>\$27,950</u>	<u>\$37,950</u>
Tax on LTCG and/or QD in 15% ordinary tax rate bracket taxed at 0%	$\$10,000 \times 0\% =$ \$0	$\$0 \times 0\% =$ \$0
LTCG and/or QD in 25% ordinary tax rate bracket taxed at 15%	$\$0 \times 15\% =$ \$0	$\$10,000 \times 15\% =$ \$1,500
Tax on LTCG and/or QD	<u>\$0</u>	<u>\$1,500</u>
10% tax rate on first \$9,325 of TI that is not LTCG and/or QD	\$933	\$933
15% tax rate on TI that is not LTCG and/or QD	$\$27,950 - \$9,325 =$ $\$18,625 \times 15\% =$ \$2,794	$\$37,950 - \$9,325 =$ $\$28,625 \times 15\% =$ \$4,294
Tax on TI that is not LTCG and/or QD	<u>\$3,727</u>	<u>\$5,227</u>
Total tax ^b	<u>\$3,727</u>	<u>\$6,727</u>
Increase in tax		<u>\$3,000</u>
MTR (additional tax / additional income) (i.e., \$3,000 / \$5,405)		<u>55.5%</u>

Notes:

^a Income is \$10,000 higher—\$5,405 from additional ordinary income, which causes \$4,595 more in SSBs (\$21,225 of \$30,000 total SSBs is now income instead of \$16,630) to become income.

^b The federal tax rate schedule is used to compute tax instead of federal tax table.

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how wide of a range does it have?). It depends on the amounts of LTCG and QD. The larger the amount of these two types of income, the longer the 55.5 percent effective MTR bracket lasts (i.e., the wider the range for such effective MTR bracket). Given the facts in Table 4, the range lasts from the beginning of the 25 percent STR bracket until \$5,405 (i.e., \$10,000 of LTCG and QD divided by 1.85) of additional ordinary income is triggered. To summarize, the width of the 55.5 percent effective MTR bracket increases as LTCG and/or QD increase but not beyond where exactly 85 percent of SSBs are included in income.

To illustrate this, start by using the amounts in the middle column of Table 4. Then assume the additional ordinary income is \$5,405 [e.g., from a 401(k) or IRA distribution] instead of \$1,000. Table 5

shows that the effective MTR is still 55.5 percent and that the entire \$10,000 of LTCG and/or QD is all taxed at a 15 percent rate. Again, the key to avoiding the 55.5 percent effective MTR in Table 5 is to not make the additional \$5,405 distribution from the 401(k) or IRA and instead withdraw or sell from an investment that does not trigger income (which will be discussed in more detail later). The first note below Table 5 explains that less than 85 percent of total SSBs are included in income. This means that further ordinary income (i.e., beyond the additional \$5,405) would be effectively taxed at a 46.25 percent marginal rate (which will be illustrated in Table 6).

The last fact, that less than 85 percent of SSBs are included in income, indicates that the 46.25 percent effective MTR bracket occurs immediately after

TABLE 6
Single Taxpayer in 2017 in 46.25 Percent MTR Bracket

	Before Additional Income	After Additional Income
Additional \$5,029 of ordinary income	\$5,405	\$10,434
Income	\$59,900 ^a	\$69,204 ^a
Sum of standard and exemption deductions	-\$11,950	-\$11,950
TI	<u>\$47,950</u>	<u>\$57,254</u>
Amount of income that is LTCG and/or QD	\$10,000	\$10,000
Amount of TI that is not LTCG and/or QD	\$37,950	\$47,254
LTCG and/or QD in 25% ordinary tax rate bracket taxed at 15%	\$10,000 × 15% = \$1,500	\$10,000 × 15% = \$1,500
10% tax rate on first \$9,325 of TI that is not LTCG and/or QD	\$933	\$933
15% tax rate on TI that is not LTCG and/or QD	\$37,950 – \$9,325 = \$28,625 × 15% = \$4,294	\$37,950 – \$9,325 = \$28,625 × 15% = \$4,294
25% tax rate on TI that is not LTCG and/or QD	\$37,950 – \$37,950 = \$0 × 25% = \$0	\$47,254 – \$37,950 = \$9,304 × 25% = \$2,326
Total tax ^b	<u>\$6,727</u>	<u>\$9,053</u>
Increase in tax		<u>\$2,326</u>
MTR (additional tax / additional income) (i.e., \$2,326 / \$5,029)		<u>46.25%</u>

Notes:

^a Income is \$9,304 higher—\$5,029 from additional ordinary income, which causes \$4,275 more in SSBs [\$25,500 of \$30,000 (i.e., exactly 85 percent) of total SSBs is now income instead of \$21,225] to become income.

^b The federal tax rate schedule is used to compute tax instead of the federal tax table.

this 55.5 percent effective MTR bracket ends and lasts until exactly 85 percent of SSBs are included in income. This is illustrated in Table 6 by comparing the amounts in the last column of Table 5 with additional income of \$5,029, at which point the maximum 85 percent of SSBs are included in income.

The key to avoiding the 46.25 percent effective MTR in Table 6 is to not make the additional \$5,029 distribution from the 401(k) or IRA and instead withdraw or sell from an investment that does not trigger income. After the 46.25 percent effective MTR bracket ends, the effective MTR bracket becomes 25 percent, the same as the STR bracket. For example, if the last column of Table 6 were compared with an increase in ordinary income of \$14,434 (i.e., a \$4,000 increase over \$10,434), then total tax would increase by \$1,000. This is a 25 percent (i.e., \$1,000 more tax on a \$4,000 increase in ordinary income) MTR bracket, the same as the STR bracket, assuming the taxpayer's income is not in any other range(s) in which a tax break is being phased out.⁹

Determining Effective MTR from Form 1040

Given the five scenarios discussed in the article where a taxpayer has a higher effective MTR than the taxpayer's STR [i.e., 15 percent instead of 10 percent, 22.5 percent or 27.75 percent instead of 15 percent, and 55.5 percent (possibly) or 46.25 percent instead of 25 percent], how can an effective MTR be determined by looking at the client's Form 1040? Tables 7 and 8 summarize such identification for the single and married filing jointly statuses.

Reviewing Tables 7 and 8, even if the financial professional has the client's complete Form 1040, determining the effective MTR can be complex, especially when the client's MTR is 55.5 percent or 46.25 percent and there is a net LTCG. In practice, how would a financial professional determine a client's effective MTR and then engage in planning if the client has a relatively high MTR? There are four ways. The first is to use Form 1040 tax software. The second is to use a free Excel spreadsheet of Form 1040 (available at <https://sites>.

TABLE 7
Effective MTR for Single Taxpayer in 2017

If Taxable SSBs Are ^a	and TI Is	STR	Effective MTR
\$0	N/A	0%, 10%, or 15% ^b	Same as STR
> \$0 and < \$4,500	< \$9,325	10%	15%
> \$0 and < \$4,500	≥ \$9,325 and < \$37,950	15%	22.5%
≥ \$4,500 and < 85%	≥ \$9,325 and < \$37,950	15%	27.75%
≥ \$4,500 and < 85% (and QD + LTCG > \$0) ^c	≥ \$37,950 and < \$37,950 + (total QD + LTCG) ^c	25%	55.5%
≥ \$4,500 and < 85%	≥ \$37,950 + (total QD + LTCG) ^c and < \$91,900	25%	46.25%
= 85%	≥ \$37,950 and < \$91,900	25%	25% (Same as STR)

Notes:

- ^a Amount from line 20b (Taxable SSBs) on Form 1040. Percentage from line 20b (Taxable SSBs) divided by line 20a (Total SSBs) on Form 1040.
- ^b Varies based on TI. See Table 1 for STR given TI.
- ^c QD from line 9b on Form 1040. LTCG from line 15, if a gain, minus line 7, if a loss, and minus lines 18 and 19 on Schedule D attached to Form 1040. Ignore the amount computed if it is less than \$0.

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google.com/site/excel1040/). The third is to purchase a subscription to Tax Clarity software, available at taxclarity.com. This product has a 10-day free trial and costs either \$49.99 per month or \$500 per year. The fourth is to purchase BNA Income Tax Planner software from Bloomberg. The cost for a site license for one user for the first year is \$708 for the federal only or \$1,148 for both federal and the 50 states, but occasional specials can reduce such initial cost by up to \$250. The annual renewal is \$585 for the former and \$844 for the latter product. A site license for an additional user is available at a fraction of the cost for one user. (The author has no financial interest in any of these products.)

With the first two products, a professional needs to run “What if” analyses similar to what was done in Tables 4, 5, and 6. In other words, use the taxpayer’s Form 1040 to input the taxpayer’s income and deduction amounts on pages 1 and 2 of the Form 1040 as well as the amounts on Schedule D (Capital Gains and Losses), and then save the file. Next, open the file, rename it, and add \$100 or \$1,000 (or some other amount) of

ordinary income [e.g., add a fully taxable IRA distribution to lines 15a and 15b or add a fully taxable 401(k) distribution to lines 16a and 16b], and then save this file with a new name. Finally, compare the tax from the two files and divide it by the additional income. (Do not divide it by the increase in TI.)

Simpler (but more costly) methods are to use either the Tax Clarity or BNA Income Tax Planner software. The former shows the different effective MTRs that a client moves through as a composition of their total amounts for federal income tax and income. The latter is the most comprehensive of all the tools. Regardless of the tool used, if the effective MTR is greater than the STR, then it is possible planning can be performed during the year and implemented by the client before the end of the year. Such planning becomes relatively more important the more that the effective MTR exceeds the STR. The key to planning is doing it before the year ends and, if possible, before too much of the year has passed so the taxpayer can make changes.¹⁰

TABLE 8
Effective MTR for Married Taxpayers Filing Jointly in 2017

If Taxable SSBs Are ^a	and TI Is	STR	Effective MTR
\$0	N/A	0%, 10%, or 15% ^b	Same as STR
> \$0 and < \$6,000	< \$18,650	10%	15%
> \$0 and < \$6,000	≥ \$18,650 and < \$75,900	15%	22.5%
≥ \$6,000 and < 85%	≥ \$18,650 and < \$75,900	15%	27.75%
≥ \$6,000 and < 85% (and QD + LTCG > \$0) ^c	≥ \$75,900 and < \$75,900 + (total QD + LTCG) ^c	25%	55.5%
≥ \$6,000 and < 85%	≥ \$75,900 + (total QD + LTCG) ^c and < \$153,100	25%	46.25%
= 85%	≥ \$75,900 and < \$153,100	25%	25% (Same as STR)

Notes:

^a Amount from line 20b (Taxable SSBs) on Form 1040. Percentage from line 20b (Taxable SSBs) divided by line 20a (Total SSBs) on Form 1040.

^b Varies based on TI. See Table 2 for STR given TI.

^c QD from line 9b on Form 1040. LTCG from line 15, if a gain, minus line 7, if a loss, and minus lines 18 and 19 on Schedule D attached to Form 1040. Ignore the amount computed if it is less than \$0.

How Many Taxpayers Are Affected by Taxable Social Security?

The most recent data available (for 2014) from the IRS's Statistics of Income division show that approximately 19.2 million individual tax returns (out of approximately 148.7 million total tax returns filed) show some (i.e., > 0 percent and up through the maximum of 85 percent) of their SSBs received are included in income.¹¹ A reasonable estimate is that approximately 10 million have less than the maximum percentage (85 percent) of SSBs included in income. For these 10 million individuals, their effective federal MTR is greater than their STR bracket. This estimate is based on the following facts: A 1998 federal government report (Joint Committee on Taxation, 1998) listed 5 million taxpayers in the SSBs phasein range out of 7.4 million total taxpayers with taxable SSBs (i.e., about 67 percent).¹² As mentioned earlier, when the phasein of SSBs begins is not indexed for inflation, it is reasonable and conservative to assume a higher percentage of taxpayers have the maximum percentage taxable (i.e., 85 percent of SSBs) now compared with about 20 years ago. Consequently, it is assumed that for the most recent year data are available, about 9 million have the maximum percentage (85 percent) of SSBs included in income, and about 10 million (i.e., about 53 percent) have some SSBs that are taxable but less than the maximum percentage.

Further, Table 9 contains data from the IRS that provide support that more people are paying federal

income tax on their SSBs every year.

The conclusion from the above data is that since the phasein of Social Security as taxable is not indexed for inflation, a lot more income and a lot more taxpayers are impacted by this law each year. Since there are approximately 19 million individual taxpayers with some SSBs in income (i.e., > 0 percent and ≤ 85 percent), again, a reasonable estimate is that there are approximately 10 million taxpayers in the range where they have to include > 0 percent but < 85 percent of SSBs in income and thus have an effective MTR higher than their STR bracket.¹³

The Need for Tax-Efficient Distribution Planning

It is well established that if an individual taxpayer's MTR in the year of contribution is greater than the MTR in the year of distribution, then a traditional retirement account [e.g., 401(k) or "deductible" IRA] ultimately results in more wealth than its Roth alternative [e.g., Roth 401(k) or Roth IRA], and vice versa. At first glance, even if an individual consistently saves for retirement throughout his or her career (e.g., 10 percent of salary is put in the individual's retirement accounts each year), it would appear that in most years during his or her career, an individual should contribute to a traditional retirement account because it is unusual to have higher TI after such individual's career ends than before while earnings from employment were still occurring. While it might be unusual for TI to be higher in retirement than during the individual's high earnings years, this article shows that for millions of individuals collecting SSBs after retiring, despite having lower TI than when in their peak earnings years, their effective MTR is significantly higher than it was in their peak earnings years (i.e., see the 55.5 percent and 46.25 percent effective MTRs in Tables 7 and 8). This occurs because the taxation of SSBs phases in as income rises and leads to the following implication for financial professionals: Making significant contributions to Roth retirement accounts while working (or conversions from an IRA to a Roth IRA after retiring

TABLE 9
Total Taxable SSBs

	1996	2005	2014
Number of Forms 1040 (millions)	7	13	19
Dollar amount (billions)	\$53	\$126	\$261

Source: IRS¹⁷

but before SSBs begin) is a tax-efficient strategy for clients who, during retirement, have a higher effective MTR than STR bracket due to the SSBs phase-in.

For these millions of individuals having some, but not the maximum percentage (85 percent), of SSBs subject to income taxation, having significant funds available inside Roth retirement accounts, and strategically distributing them can save income tax at a surprisingly high rate. Financial service professionals can add great value for their clients who are collecting SSBs by assisting them with tax-efficient withdrawals (also called decumulation, spend-down, or draw-down) during retirement.

Reducing Present Value of Retired Clients' Taxes

The SSBs phase-in thus is one important reason why MTR can be higher during retirement than it is during earlier years when the individual was employed and had either salary or net profit from being self-employed. A financial professional wants to advise a client in the situations described above (where effective MTR is higher than STR) how to generate cash to finance spending needs that does not cause PI to rise further (i.e., does not cause more of SSBs to be taxable). How? Municipal bond interest is included in provisional income, so investing in municipal bonds does not solve this tax torpedo. In contrast, taking a distribution from a Roth retirement account does not increase how much in SSBs is included in income. So the goal is to have some tax-free source(s) of funds available to avoid part of, or hopefully all of, the very high effective MTRs (e.g., 55.5 percent and 46.25 percent) that plague millions of SSBs recipients. In addition to a tax-free source of funds being Roth retirement accounts, reimbursement for current-year or prior-year qualified medical expenses from an HSA is also such a source. Another source is investments outside of Roth retirement accounts and HSAs (e.g., a taxable brokerage account) where the tax basis equals (e.g., money market accounts and CDs) or exceeds (e.g., some investment-grade bond funds and "losing" stocks and stock funds) the fair market value, so no

income is triggered at the sale of such investments.

So to summarize, any source of funds that either reduces PI or does not cause it to rise can minimize the amount of SSBs included in income. For example, not taking 401(k) or IRA distributions beyond the required minimums can prevent more SSBs from becoming income. Another way to reduce PI is to recognize a capital loss, particularly to offset a capital gain, on an investment held outside of a retirement account. Keep in mind that capital losses reduce PI only to the extent that the net capital loss for the year is less than \$3,000—the maximum allowable annual deduction.

Another strategy, for a client over age 70½ who makes charitable contributions, is a qualified charitable distribution (QCD). A QCD reduces PI compared with taking required minimum distributions (RMDs) and then donating cash to charity. A QCD sends some RMDs from an IRA directly to a qualifying charity, thus avoiding an increase in PI like that which receiving the full RMD would trigger. The charitable contribution is not deductible, but avoiding income on the RMD sent to the charitable organization(s) can help avoid all or a significant portion of the tax torpedo.

Where Is the Tax Return Preparer?

Why is it rare that CPAs and other tax return preparers pick up on these high MTRs and then provide proper advice to the taxpayer? There are multiple reasons. First, they have a compressed workload before mid-April's tax filing deadline, so there is little time for planning and advice. Second, the tax return preparation software they use does not break out income and tax into all of the relevant effective MTR brackets. Third, the tax does not look relatively high unless it is compared with what the tax would be on the last (for example) \$1,000, or \$5,000, or \$10,000 of income. On the last reason, analyzing the last columns of Tables 5 and 6 is relevant. For example, in Table 6's last column, the tax of \$9,053 on a single individual's income of \$69,204 does not sound high, since it is only 13.1 percent. But it is outrageously high when compared with the middle column, which shows that

on the last \$5,029 of ordinary income, the tax increase was \$2,326, a 46.25 percent rate. Similarly, in the last column of Table 5, the tax of \$6,727 on a single individual's income of \$59,900 does not sound high, since it is only 11.2 percent. But it is infuriatingly high when compared with the middle column, which shows that on the last \$5,405 of ordinary income, the tax increase was \$3,000, a 55.5 percent rate. If only the financial advisor had gotten involved partway through the previous year to advise the client to avoid as much of that last \$10,434 (i.e., \$5,029 + \$5,405) of ordinary income as possible, large tax savings could have resulted.

On the one hand, if the client's entire income was composed of only SSBs and RMDs from 401(k)s and IRAs, then the possibility of high effective MTRs could not be avoided. However, some clients have other sources of income on their tax returns, some of which are controllable and could be avoided through tax-efficient withdrawal planning. Generating needed cash flow from sources that trigger little to no income (e.g., Roth retirement accounts) while not increasing 401(k) and IRA distributions is a tax-efficient withdrawal strategy for taxpayers in this situation, where SSBs are taxed at unusually high effective MTRs.

Provide This Service Every Year to Retirees

Should a financial professional wait until a client is in a very high effective MTR bracket (see Tables 7 and 8) to begin tax-efficient withdrawal planning, or is there anything the advisor can do when the client begins retirement to avoid, as much as possible, such occurrence? The answer is that tax-efficient withdrawal planning should be done every single year during retirement and should begin before RMDs and possibly even SSBs begin. To assist in such planning, the financial planner or the client can estimate SSBs to be received annually by logging in at www.ssa.gov, where they will find estimated SSBs at full retirement age. Clicking on "View Estimated Benefits," they will also find estimated SSBs at both early retirement age (62) and age 70.

Kirsten Cook et al. in "Tax-Efficient Withdrawal

Strategies" explain how tax-efficient withdrawal strategies early in retirement (e.g., during the client's sixties) can lead to a much-less-significant Social Security tax torpedo issue later in retirement.¹⁴ To summarize their findings, in the early years of retirement, particularly before RMDs and, possibly, SSBs begin, clients are often in a relatively low tax bracket because they are typically funding their spending needs from taxable (e.g., brokerage) accounts, many of which trigger little or no income. So, to lessen the tax torpedo later, it is often a wise idea to convert an amount from an IRA to a Roth IRA to the extent that such conversion's income causes the 15 percent STR bracket to be fully utilized. This helps to create more future distributions from Roth IRAs while triggering some, but not a large amount of, tax during such early years of retirement. So, again, financial professionals have the opportunity to be involved in determining a tax-efficient withdrawal strategy every year once a client retires.

Conclusion

A client's effective MTR is significantly higher than the STR bracket that the client's TI places the client in if the inclusion of the client's SSBs is phasing in (i.e., some SSBs are taxable but the amount is less than the maximum of 85 percent). Specifically, the ordinary STR brackets of 0 percent, 10 percent, 15 percent, 25 percent, and so on, change to effective MTRs of 0 percent, 15 percent, 22.5 percent, 27.75 percent, 55.5 percent (possibly), 46.25 percent, 25 percent, and so on. This article builds on Geisler and Hulse's 2016 article.¹⁵ It expands into taxpayers with a 55.5 percent effective MTR due to being in the 25 percent STR bracket and having SSBs included in income phasing-in while having some QD and/or net LTCG as income. Finally, it further develops exactly how a financial professional can add value by assisting retired clients with income tax planning.

Financial professionals have an opportunity to increase and improve the services they provide by planning tax-efficient withdrawals during every year of retirement for clients. A couple of key strategies are

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the following: Keep TI low enough so it avoids the 25 percent STR bracket for clients with SSBs phasing in (thus avoiding the 55.5 percent and 46.25 percent effective MTR brackets); and before SSBs begin, fully utilize the 0 percent, 10 percent, and 15 percent STR brackets by conversions of an IRA to a Roth IRA to take TI to the top of the 15 percent STR bracket.¹⁶ ■

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(1) The term “tax torpedo” has been used in many articles including the following: Neal R. VanZante and Ralph B. Fritzch, “Don’t Let Social Security Torpedo the Roth IRA Conversion Decision,” *CPA Journal* 81, No. 4 (2011): 56–57; and William Meyer and William Reichenstein, “The Tax Torpedo: Coordinating Social Security with a Withdrawal Strategy to Minimize Taxes,” *Retirement Management Journal* 3, No.1 (2013): 25–32.

(2) Whether or not these higher effective MTRs apply to a particular taxpayer depends on the level of SSBs. For 2017, if an individual is turning age 66 (i.e., full retirement age) and begins SSBs, the maximum annual SSBs are \$32,244. “What Is the Maximum Social Security Retirement Benefit Payable?” *SocialSecurity.gov*; accessed at: <https://faq.ssa.gov/link/portal/34011/34019/article/3735/what-is-the-maximum-social-security-retirement-benefit-payable>. This article assumes relatively large amounts of SSBs, so all of the higher effective MTRs apply.

(3) This article focuses on the two most likely filing statuses for clients of financial service providers—single and married filing jointly—and, for brevity, ignores the other two filing statuses—head of household and married filing separately.

(4) Another assumption is that AGI is below \$250,000 for married couples filing one joint tax return and below \$200,000 for unmarried individuals. The additional Medicare surtax of 3.8 percent on investment income which includes LTCGs and QDs thus does not apply, because these AGI thresholds are not exceeded.

(5) Greg Geisler and David Hulse, “The Taxation of Social Security Benefits and Planning Implications,” *Journal of Financial Planning* 29, No. 5 (2016): 52–63.

(6) All Form 1040 line numbers are from 2016, since the 2017 Form 1040 is not published until late in 2017.

(7) Despite the lower STRs that apply to LTCG and QD, the way tax is computed is unfavorable when a taxpayer moves from the 15 percent to the 25 percent STR bracket, even when there are no SSBs. The MTR when a taxpayer moves from the 15 percent to the 25 percent STR bracket and has LTCG and QD (in excess of how much TI is in the 25 percent

bracket) is 30 percent, not 15 percent. Endnote 8 will illustrate this fact. (8) In contrast, assume the same amounts of AGI (\$49,900) and TI (\$37,950) and portion of income from QD and LTCG (\$10,000) but no SSBs (i.e., the other \$39,900 of income is ordinary). Total tax is again \$3,727 (i.e., the same as the middle column). After adding \$1,000 more ordinary income, TI becomes \$38,950 and total tax is \$300 higher (i.e., \$4,027) because \$1,000 of LTCG and/or QD is now taxed at 15 percent (\$150 more tax) instead of 0 percent and \$1,000 more ordinary income is taxed at 15 percent (another \$150 increase in tax). The MTR on the additional ordinary income of \$1,000 is thus 30 percent in this scenario (where there are no SSBs), instead of the 55.5 percent MTR in Table 4 (where there are SSBs).

(9) The following article includes a complete list of tax break phase-outs for individuals: Gregory G. Geisler, “Federal Income Tax Laws That Cause Individuals’ Marginal and Statutory Tax Rates to Differ,” *Journal of Accounting Education* 31, No. 4 (2013): 430–460.

(10) Since Form 1040 tax software for the current year is not released until around Thanksgiving, if the planning is done more toward the middle of the year, last year’s software must be used while substituting in the current year’s projected amounts of income and deductions.

(11) “SOI Tax Stats—Individual Statistical Tables by Filing Status,” *IRS.gov*, Table 1.3 (2014 spreadsheet), August 31, 2016; accessed at: <https://www.irs.gov/uac/soi-tax-stats-individual-statistical-tables-by-filing-status>.

(12) This is the most recent federal government report to estimate the number of individual taxpayers in the SSBs phase-in range (i.e., > 0 percent and < 85 percent of SSBs are taxable): U.S. Congress, Joint Committee on Taxation, *Present Law and Analysis Relating to Individual Effective Marginal Tax Rates* (JCS-3-98; Washington, DC: U.S. Government Printing Office, February 3, 1998); accessed at: <http://www.jct.gov/publications.html>.

(13) Further support for this estimate of 10 million taxpayers having some, but less than the maximum percentage of, taxable SSBs is the following: there are 3.4 million taxpayers with taxable SSBs who have adjusted gross income between \$15,000 and \$30,000—practically all of whom should be included in the 10 million; there are 4.0 million taxpayers with taxable SSBs who have adjusted gross income between \$30,000 and \$50,000—practically all of whom should be included in the 10 million; and there are 7.0 million taxpayers with taxable SSBs who have adjusted gross income between \$50,000 and \$100,000—approximately half (an estimate) of whom should be included in the 10 million. This sums to 10.9 (i.e., 3.4 + 4.0 + ½ × 7.0) million taxpayers, which, to be conservative, is rounded down to 10 million.

(14) Kirsten Cook et al., “Tax-Efficient Withdrawal Strategies,” *Financial Analysts Journal* 71, No. 2 (2015): 16–29.

(15) Geisler and David (2016), endnote 5.

(16) See Tables 1 and 2 for how much TI should be to fully use the 15 percent STR bracket and avoid the 25 percent STR bracket in 2017, but remember that the tax rate schedules are indexed for inflation every year.

(17) “SOI Tax Stats—Individual Statistical Tables by Filing Status,” *IRS.gov*, Table 1.3 (1996 and 2005 spreadsheets), August 31, 2016; accessed at: <https://www.irs.gov/uac/soi-tax-stats-individual-statistical-tables-by-filing-status>.