

Avoiding The Social Security Benefit Tax

Retirees also can use annuities to avoid or reduce the Social Security benefit tax. For individuals who receive Social Security benefits, the IRS made life more complicated. If these individuals (and their spouses) have income exceeding certain levels, Social Security benefits become taxable. In this context, "income" means wages, pension benefits, investment and interest earnings (taxable and tax free) and Social Security payments. The formula used to determine the taxation of Social Security benefits can result in up to 85 percent of those benefits being taxed.

The formula differentiates between single and married taxpayers and applies two step-rate thresholds to the taxpayer's adjusted gross income. For single filers, the thresholds are set at \$25,000 and \$34,000; for married couples, the thresholds are \$32,000 and \$44,000. To the extent that income exceeds these thresholds, some amount of the taxpayer's Social Security benefit is taxable. The amount subject to taxation is the least of a three-part comparison. (The formula for determining the taxation of Social Security benefits is described below).

Formula for Determining Taxation of Social Security Benefits

- Step 1: Determine modified AGI (total of earnings, pension benefits, dividends and taxable and tax-free interest from investments and other sources, plus 50 percent of Social Security benefits)
- Step 2: Determine modified AGI that exceeds first threshold (\$25,000 for single filers, \$32,000 for joint filers)
- Step 3: Determine modified AGI that exceeds second threshold (\$34,000 for single filers, \$44,000 for joint filers)
- Determine smallest of:
- a. 50 percent of excess over first threshold plus
35 percent of excess over second threshold
 - or
 - Step 4: b. 85 percent of Social Security benefits
 - or
 - c. 50 percent of Social Security benefits plus
85 percent of excess over second threshold

The smallest of the three figures in Step 4 is the amount of Social Security benefits subject to tax. An example of this calculation is provided at the bottom of the page.

It is important to emphasize that for this purpose, income includes both earned and investment income, taxable and tax free. In other words, interest from savings accounts, CDs, corporate bonds and municipal bonds all count toward the thresholds. If income exceeds these step-rate thresholds, up to 85 percent of the Social Security benefit could be taxed.

To the extent that investment income is not needed to fund retirement, an annuity can help protect a retired individual from the taxation of his or her Social Security benefits. To illustrate this, consider an example. Joe, who is married, has \$400,000 in income-producing investments, some

taxable, some tax free. These investments generate \$29,000 a year in income (\$300,000 at 8 percent [taxable] and \$100,000 at 5 percent [tax free]). In addition, Joe receives a \$25,000 pension and a \$10,000 Social Security benefit. For purposes of the Social Security benefit tax, Joe's income is \$59,000 - the interest income plus his pension plus half of his Social Security benefit.

But Joe doesn't need the \$29,000 he receives as income from his investments. Currently, he simply reinvests those earnings. If he were to shift the \$400,000 of investments into an annuity, the Social Security tax would be eliminated.

Many variations on this concept can be tailored to meet an individual prospect's needs and circumstances. The key to remember is that most individuals hate to pay taxes, especially when it comes to their Social Security benefits.

Taxation of Social Security Benefits

1. Modified AGI

i.	Pension Benefits	\$25,000
ii.	50 Percent of Social Security Benefits	\$5,000
iii.	Investment income	
a.	\$300,000 @ 6 percent	\$24,000
b.	\$100,000 @ 5 percent	<u>\$5,000</u>
iv.	Total	\$59,000

2. Income exceeding first threshold of \$32,000 (\$59,000 - \$32,000) \$27,000

3. Income exceeding second threshold of \$44,000 (\$59,000 - \$44,000) \$15,000

4. Determine the smallest of:

a.	50 percent of excess over first threshold plus 35 percent of excess over second threshold [(.50 x \$27,000) + (.35 x \$15,000)]	\$18,750
b.	85 percent of Social Security benefits	\$8,500
c.	50 percent of Social Security benefits plus 85 percent of excess over second threshold [\$5,000 + (.85 x \$15,000)]	\$17,750

5. Amount of Social Security benefit subject to tax (smallest of a, b or c in Step 4) \$8,500

The following table compares the results with and without an annuity:

	Without an Annuity	With an Annuity
Income		
Pension	\$25,000	\$25,000
Includable Social Security benefits	\$5,000	\$5,000
Investment Income		
\$300,000 @ 8 percent	\$24,000	\$0*
\$100,000 @ 5 percent	\$5,000	\$0*
Annuity earnings @ 8 percent		\$32,000
Total income and earnings	\$59,000	\$62,000
Income included in Social Security benefit calculation	\$59,000	\$30,000**
Social Security benefits subject to tax	\$8,500	\$0
Taxes on Social Security benefit @ 31 percent	\$2,635	\$0