Improving Your Finances

How to Avoid Blowback From 'The Tax Torpedo'

Limiting the taxation of Social Security benefits is another reason to aim for tax diversification.

By Christine Benz | 03-07-13 |

Stocks are hitting new highs by the day, and bond yields are miserly. Could you blame any pre-retiree or retiree for feeling nervous? Even though account balances have trended up nicely since the market bottomed four years ago, the key ingredients for strong future portfolio performance look disappointing.

At times like these, an investor's best friend is a checklist of what she can truly control. That means crafting a sensible asset-allocation plan, making sure your planned in-retirement spending rate is reasonable, and limiting investment-related costs at every turn. It also means paying close attention to how taxes affect your assets and your spendable income.

Tax Maneuvering Matters More in Retirement

For many people, that last lever--controlling taxes--becomes even more meaningful during retirement than it did while they were working. Sure, accumulators can control the tax bill from their investments by saving in tax-deferred accounts and employing proper asset location; they can also maximize their credits and deductions, thereby reducing their yearly income tax bills. But when you're working and earning a paycheck, your income is what it is, and much of it will be taxable.

Retirees who are looking to their portfolios for living expenses, by contrast, actually may be able to exert a fair amount of control over their tax bills, particularly if they have spread their assets across multiple account types: tax-deferred (traditional IRAs and 401(k)s), Roth, and taxable. If they're required to take minimum distributions from tax-deferred accounts, that counts as taxable income whether they like it or not. But if they have other accounts that they can draw upon for living expenses--specifically, Roth IRA assets or taxable accounts--withdrawals have fewer tax implications. Flexibility and control are the key benefits of tax diversification.

The Torpedo and Who It Affects

The benefits of limiting taxes during retirement may seem obvious. But one less frequently discussed consideration is the interplay between adjusted gross income and Social Security benefits. If a single retiree's adjusted income from her portfolio, plus tax-free income and one half of Social Security income (a combination that is called provisional income), exceeds $25,000, then up to half of her benefit will be taxable; that threshold increases to $32,000 for married couples filing jointly. But if provisional income exceeds $34,000 for single filers and $44,000 for married couples filing jointly, 85% of the Social Security benefit will be taxable.

That differential--the dramatic jump up from 50% taxation on benefits to 85%--is what seniors and retirement-planning experts sometimes call "the tax torpedo." With only a modest increase in income, a senior can see her taxes jump up significantly.

Seniors at opposite ends of the income spectrum won't need to spend a lot of time strategizing about Social Security taxation. The affluent will pay the full freight--85% of their benefits will be taxable, assuming their provisional income exceeds $34,000 for single

filers and $44,000 for couples--and seniors for whom Social Security is their sole or main income won't be taxed on their benefits. But seniors in the middle of that spectrum have a strong incentive to make sure that they stay out of the next-highest band. For example, couples who have about $30,000 in provisional income have a strong incentive to stay under that $32,000 mark, thereby keeping their benefits free of taxation. Meanwhile, those couples whose provisional incomes are bumping around in the $40,000 range will want to do everything they can to stay under the $44,000 threshold, the point at which benefits are 85% taxable.

What You Can Do

Getting your arms around whether and how your Social Security benefits are taxable is a good starting point to determine whether you should care about this issue. The worksheet on page 29 of the 1040 Instruction booklet helps you calculate your provisional income to arrive at the percentage of your benefits that will be taxed, and online calculators an also help.

As you can see, as you enter your information into the calculator or worksheet, the interplay between your various income sources--Social Security, pension income, and income and withdrawals from various account types--can increase or decrease the amount of Social Security benefits that are taxable. Yet figuring out how to manipulate these different income sources to reduce Social Security taxation is complicated stuff. Boglehead *nisiprius* made me chuckle with this comment on the Bogleheads' website: "I concluded that the chances of planning around this or doing anything sensible about it are about the same as the chances of planning to make sure your adjusted gross income doesn't contain the digits 2 or 6 in it, and that I wasn't going to worry about it."

That said, there are some best practices to bear in mind when thinking about Social Security benefit taxation. Clearly, maintaining tax diversification in a portfolio can give a retiree a lot more control over the overall tax they pay in a given year as well as the taxation of their Social Security benefits. In particular, Roth assets, withdrawals from which are not taxable in retirement, are a key lever that retirees can use to limit tax on Social Security benefits. That means that retirees and pre-retirees who appear likely to fall into the tax torpedo zone might consider converting some of their traditional IRA assets to Roth; as with any conversion decision, consult with a tax advisor to make sure you're thinking through all of the implications.

Additionally, accumulators whose portfolios are heavily skewed toward traditional IRAs and 401(k)s might consider steering new contributions to Roth accounts, either directly or via a backdoor maneuver. Finally, retirees may find value in consulting with a tax advisor not just at tax time, but also as they decide which asset pools to liquidate to make sure they're taking every step they can to limit their tax hit on an ongoing basis.

About the Author
Christine Benz is Morningstar's director of personal finance and author of *30-Minute Money Solutions: A Step-by-Step Guide to Managing Your Finances* and the *Morningstar Guide to Mutual Funds: 5-Star Strategies for Success*.
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