When an RMD knocks you in range of the Social Security "*tax torpedo*"

Excerpts by Brent Hunsberger/ itsonlymoneyblog@gmail.com

Neil Malling, 71, of Portland, saw his marginal tax rate just about double after he withdrew $9,000 from his traditional IRA, as required by law. He and other seniors fall victim to quirks in the U.S. tax code that suddenly increase the amount of Social Security benefits subject to tax.

As an investment adviser, Neil Malling encouraged clients to save all they could in their 401ks and IRAs. He did the same.

"I drank the IRA cool-aid all the way," the Portland resident says today.

But last year, after turning 70-and-a-half and taking his first required IRA distribution, he revised his advice. That's because his federal tax bill jumped from $1,700 to $4,700, mostly because of a $9,000 taxable withdrawal from his traditional IRA.

How does a senior in the 15% tax bracket wind up paying a 30% tax on his IRA distribution?

"It's totally contrary to what the IRA was set up for," Malling says.

Malling and several million other seniors are falling victim to tax-code wrinkles that essentially cause a higher percentage of their Social Security income to be taxed when they draw money from their retirement plans.

Required Minimum Distributions

Remember, once a retiree reaches 70-and-a-half, they are required to begin taking money out of their traditional IRAs and workplace retirement plans each year. These withdrawals are calculated using the IRS life-expectancy tables. The larger your tax-deferred retirement savings, the larger your mandatory withdrawals.

This so-called **"Social Security tax torpedo"** stands to nip more and more retirees in the bud as each year passes. But it doesn't get much attention, for several reasons.

It's complicated to understand and explain. It generally doesn't hit until you're 71. It affects the middle class – not the wealthier clientele of financial planners and CPAs, who would have the industry lobbyists and assets to make noise. And the strategies to avoid it require us to overcome our own behavioral impulses and ignore a mantra peddled for years by the finance industry.

Initially, in fact, I didn't believe Malling's analysis of his situation.

"Everybody says, 'Well that can't be right,'" says Malling, who also ran his own financial-services software firm. "I mentioned it to my poker group and they said, 'You must've really screwed up your taxes.'"

So, let me try to explain the torpedo as well as I can.

Tax on Social Security benefits

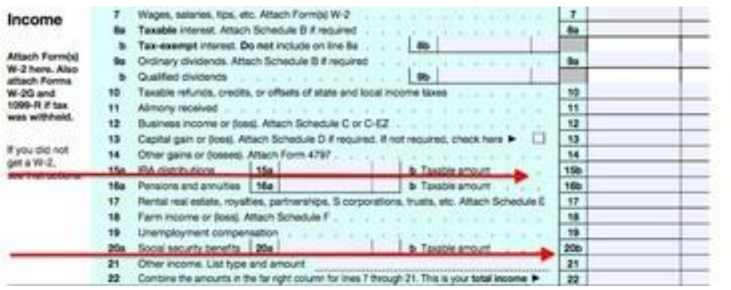
First, understand this: Uncle Sam taxes Social Security benefits when your overall income reaches certain thresholds.

- At the first threshold, 50 cents of every $1 in Social Security benefits is subject to tax.
- At the second threshold, 85 cents of every $1 in benefits is taxed.

About half of Social Security recipients never reach these thresholds, according to the Congressional Budget Office. Their benefits and other income aren't high enough, so they pay no tax on the Social Security money.

But at least 16% are just at the cusp of the threshold, said Bruce Schobel, a former actuary. For this group of people, the required minimum distributions can quickly change their tax bill. Those withdrawals can send retirees past the second threshold, where 85% of benefits are taxed. *That's when funky things happen*.

At certain (and relatively low) income levels, every $1 of required IRA withdrawal can raise your taxable income by $1.50 or $1.85. Why? The money gets taxed as $1 of ordinary income at your typical marginal tax rate. But it also **triggers an additional 50 to 85 cents of Social Security income to be added to your adjusted gross income.**


Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see instructions.

7 Wages, salaries, tips, etc. Attach Form(s) W-2 — 7
8a Taxable interest. Attach Schedule B if required — 8a
b Tax-exempt interest. Do not include on line 8a — 8b
9a Ordinary dividends. Attach Schedule B if required — 9a
b Qualified dividends — 9b
10 Taxable refunds, credits, or offsets of state and local income taxes — 10
11 Alimony received — 11
12 Business income or (loss). Attach Schedule C or C-EZ — 12
13 Capital gain or (loss). Attach Schedule D if required. If not required, check here ► — 13
14 Other gains or (losses). Attach Form 4797 — 14
15a IRA distributions — 15a — b Taxable amount — 15b
16a Pensions and annuities — 16a — b Taxable amount — 16b
17 Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E — 17
18 Farm income or (loss). Attach Schedule F — 18
19 Unemployment compensation — 19
20a Social security benefits — 20a — b Taxable amount — 20b
21 Other income. List type and amount — 21
22 Combine the amounts in the far right column for lines 7 through 21. This is your **total income** ► — 22

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You can see how this happen by looking at Form 1040 to the left. IRA distributions are reported on one line (line 15). But that withdrawal can also increase the taxable amount of Social Security benefits, reported separately on line 20.

"Instead of having to pay tax on $100, you can find yourself having to pay tax on $185," Schobel said while vice president and actuary of New York Life Insurance Co.

An 85% tax rate increase

That's what happened to Malling. His $9,000 IRA withdrawal boosted his adjusted gross income by nearly $17,000.

Looking at it another way, **when taxpayers fall within range of the torpedo, their tax rate suddenly increases by as much as 85%.** So, someone in the 15% tax bracket suddenly sees their tax rate on their IRA income jump by 85%, to 27.8%.

It can be even worse for some single taxpayers who fall into the 25% tax bracket on taxable income that exceeds $36,900. At that point, if their Social Security benefits are high enough, their tax rate might jump temporarily by 85% to 46.25%. So, the next $3,000 of their taxable income could be taxed at a higher rate than that assessed America's wealthiest taxpayers, Meyers says. After that, their tax rate drops back down to 25%.

These retirees are middle- and upper-middle income Americans whose benefits might previously have escaped tax. They're essentially phasing into the Social Security tax when they take their required distribution and the torpedo strikes.

The ranks of those affected will grow in the years ahead. The first Baby Boomers aren't yet 71. And the income thresholds I referred to earlier aren't adjusted for inflation, so they snag more taxpayers each year. Today, less than one-third of all Social Security benefits are taxed, the Congressional Budget Office estimated recently. In 25 years, half of all benefits will be taxed.

Malling's case was slightly worse because of other cascading effects. Malling and his wife deduct a sizable chunk of medical expenses. Because of the way that deduction works, when his adjusted gross income jumped, the amount of medical expenses he could deduct fell.

As a result, his $9,000 IRA distribution ended up increasing his taxable income by $18,000, or twice his IRA withdrawal.

How can you tell if this impacts you? It's difficult because the torpedo's range varies based on the size of your Social Security benefits, the size of your IRA withdrawal and the amounts of what the IRS calls your **"combined income."**

Seniors with between $300,000 and $2 million in their retirement accounts can get snared by it, Meyers said. That's especially true for couples with between $26,000 and $54,900 of income. Singles with between $23,000 and $39,500 of combined income can get socked by it, too.

The **"combined income"** amount used to determine whether Social Security benefits get taxed, is not straightforward either. It requires you to add any interest you received from tax-exempt bonds and foreign income to your adjusted gross income to determine whether 50% or 85% of your benefits are taxed.

As you see, it can be tough to estimate if you'll get caught. You must do some careful projections, probably with the help of a licensed tax consultant, CPA or retirement advisor who does tax projections or tax planning and is familiar with the issue.