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How to Cut Your Social Security Taxes

Many retirees are dismayed to learn that they owe taxes on a portion of their benefits. But you can take steps to minimize the pain.

Newsletter

(Image credit: Getty)

BY SANDRA BLOCK
PUBLISHED 10 DAYS AGO

After decades of having Social Security taxes withheld from your paycheck, you may not expect to pay taxes on the benefits you've earned. But if you have other sources of income, such as a job, a pension or withdrawals from tax-deferred retirement savings plans, there's a good chance you'll pay taxes on up to 85% of your benefits. Depending on where you live, your state may tax your benefits, too.

The government started tax… al Security benefits 40 years ago as part of an overhaul designed to shore up the pr… gislation signed by President Ronald Reagan in 1983 imposed taxes on up to 50… ee's income exceeded specific limits. Ten years later, President Bill Clinton sign… de up to 85% of benefits taxable for retirees whose earnings exceeded a secon…

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Figuring the tax bite. The… what Social Security defines as a beneficiary's provisional income, sometimes referre… me. Your provisional income is based on half of your Social Security benefits, pl… contribute to your adjusted gross income, including wages from a job, withdrawals fr… erred accounts, and dividends, interest and capital gains from taxable investment ac… municipal bonds, which is generally tax-free, is also included when calculating… me. If your provisional income ranges from $25,000 to $34,000 for single filers, o… for joint filers, up to 50% of your benefits will be taxable. If your provisional income…, or $44,000 for joint filers, up to 85% of your benefits will be taxable (see below).

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How taxes are calculated

	PI IN	% OF SOCIAL SECURITY BENEFITS THAT ARE TAXABLE
Single filers	$2	up to 50%
	Al	up to 85%
Married couples filing jointly	$3	up to 50%
	Al	up to 85%

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Taxes on Social Security be... our provisional income, which is made up of half of your Social Security benefits, yo... gross income and tax-exempt interest.

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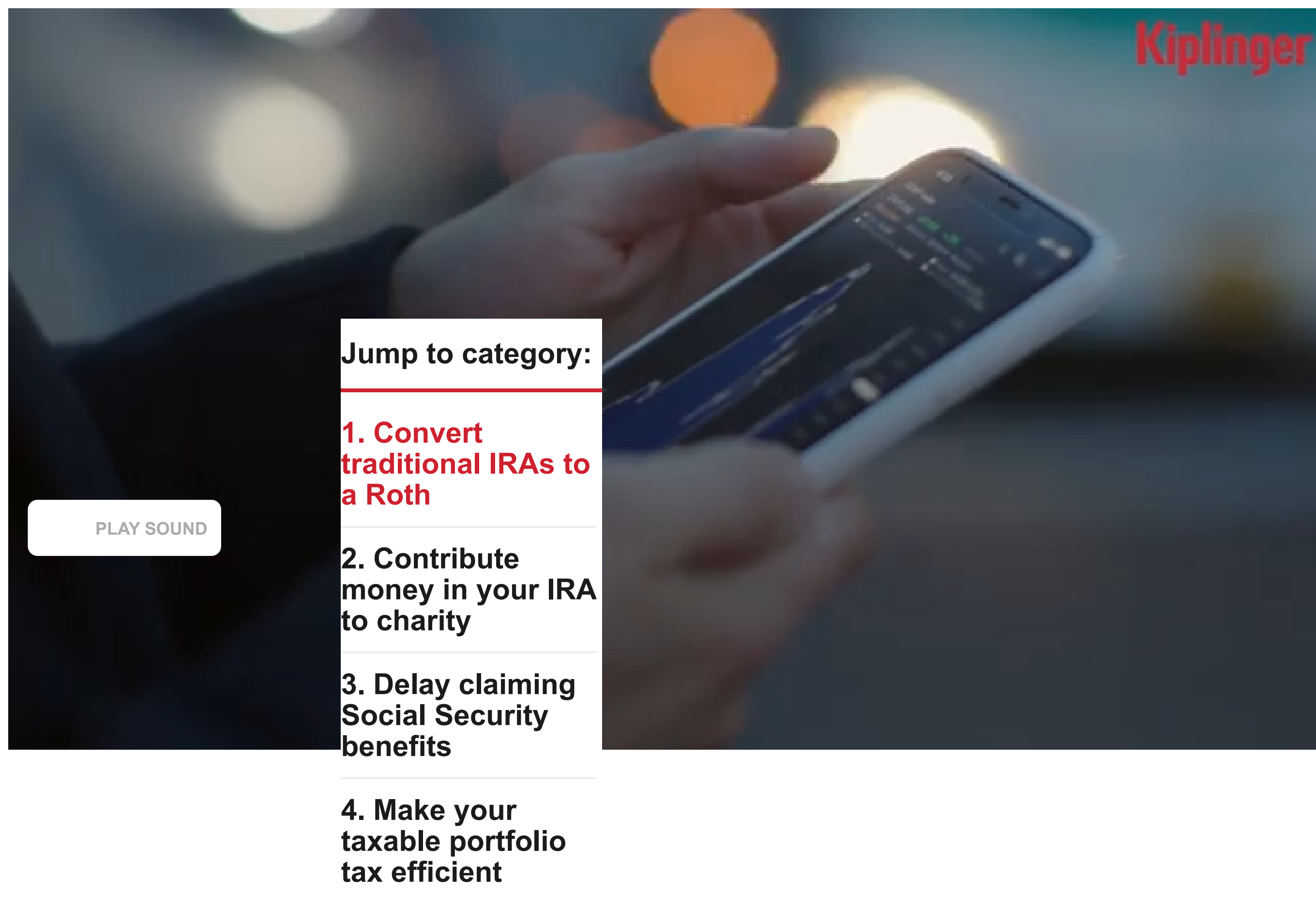

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These thresholds were never adjusted for inflation, which means the percentage of retirees who pay taxes on their benefits has increased dramatically since the tax was signed into law. In 2020, an estimated 56% of retirees were paying taxes on a portion of their benefits, according to the Center for Retirement Research at Boston College. The center projects that 58% of beneficiaries will pay taxes on their benefits in 2030. If most of your retirement income comes from Social Security, you probably won't have to pay taxes on your benefits. But beneficiaries who have income from other sources, such as a job or withdrawals from traditional IRAs, will likely end up paying taxes on a portion of their benefits, says Roger Young, a certified financial planner with T. Rowe Price.

In some cases, the tax bite can be severe. Retirees in the 22% federal tax bracket with above-average Social Security benefits, for example, could end up paying a marginal tax rate of up to 40.7% on their income, according to an analysis by T. Rowe Price. (Keep in mind that your marginal tax rate applies to only a portion of your income, not the entire amount.) And even a small increase in your taxable income could significantly increase taxes on your benefits.

T. Rowe Price provides this example: Suppose a couple collects $70,000 in Social Security benefits, and their only other income is $65,000 in withdrawals from traditional IRAs. At this level of provisional income, 50% of their benefits will be taxed. However, if that couple withdraws an additional $1,000 from their IRA, they'll cross the 85% threshold, which means an additional $850 of their benefits will be taxed, adding $407 to their tax bill.

What's the Social Security COLA?

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A large cost-of-living adjus[illegible] magnify the tax bite. In 2023, beneficiaries received an 8.7% COLA, although a sl[illegible] will likely lead to a more modest increase in 2024. Because the thresholds are [illegible] growth or inflation, increasing the benefit amount means more of those payouts will [illegible] ng the net benefit of a cost-of-living increase, Alicia Munnell, director of the Ce[illegible] Research, said in a 2021 brief.

Some lawmakers, no doubt [illegible] laints from aggrieved older constituents, have proposed exempting Social Security [illegible] Others have proposed indexing the thresholds to inflation. But any reforms that would [illegible] ity's funding are unlikely to go anywhere. Taxes on benefits contributed $47 bi[illegible] n 2022. In its annual report to Congress in April, the Social Security Board of T[illegible] ss Congress shores up the program, Social Security will be unable to pay retirees their [illegible] in 2034, a year earlier than had been projected in 2022. If the trust fund is depleted, Social Security will be able to pay retirees only about 77% of their scheduled benefits.

Four strategies to trim the tax tab

With that in mind, the wisest course of action is to look for ways to lower taxes on your benefits.

1. CONVERT TRADITIONAL IRAS TO A ROTH

Unlike withdrawals from a traditional IRA or 401(k) plan, withdrawals from a Roth won't increase taxes on your benefits. As long as you've had a Roth account for at least five years and you are 59½ or older, withdrawals are tax-free, which means they won't be included in your provisional income.

When you convert money in a traditional IRA to a Roth, you must pay taxes on the amount you convert (although part of the conversion won't be taxed if you've made nondeductible contributions to your IRA). You're not required to convert the entire amount in your tax-deferred accounts at once, and you probably shouldn't, because a large conversion could push you into a higher tax bracket.

Endeavor to convert just enough each year to remain within your tax bracket, with the goal of completing your conversions before you must start taking required minimum distributions (at age 73 in 2023, increasing to 75 in 2033). Once you start taking RMDs, you can't convert money in a traditional IRA (or other tax-deferred accounts) to a Roth until you've taken your required distribution for the year and that could result in an outsized tax bill. If you're still working, diverting some of your retirement contributions to a Roth 401(k) will also help lower taxes on your benefits when you file for Social Security, because withdrawals from those accounts will also be tax-free.

SECURE Act 2.0, signed into law in late 2022, has made it easier to stash more money in a Roth 401(k) if your employer offers one (yers do). Starting this year, if you have a Roth 401(k), you can request that your e contributions go into that account. (It may take a while for employers to update their p nake this option available.) In addition, participants in SEP and SIMPLE retirement pl to make after-tax contributions to a Roth account. Previously, contributions to provide a way for self-employed workers and employees of small businesses to save limited to pretax contributions. Although this provision takes effect this year, the R t be available until 2024 because plan custodians will need time to implement the nece

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2. CONT EY IN YOUR IRA TO CHARITY

A qualified charitable distr nation that is made directly from your IRA to a qualified charity. While a QCD is often promoted as a way to lower taxes on required minimum distributions from your IRA, it will also reduce your adjusted gross income, which means it can lower taxes on your Social Security benefits, too.

You can make a QCD as early as age 70½, but when you reach the age at which you're required to take distributions, the charitable distribution will count toward your RMD. While a QCD isn't deductible, it will reduce your adjusted gross income, which will in turn reduce the provisional income used to calculate taxes on your benefits. In order to take advantage of this tax break, your charitable gifts must be made directly from your IRA to the charity. In addition, you can't make a QCD to a donor-advised fund or private foundation, and the recipient must be a 501(c)(3) charity registered with the IRS.

3. DELAY CLAIMING SOCIAL SECURITY BENEFITS

At first blush, this strategy may sound counterintuitive because it will increase the amount of Social Security benefits included in your provisional income. If you wait until age 70 to file, you'll receive an 8% delayed-retirement credit for every year you delay after your full retirement age (66 if you were born between 1943 and 1954, rising to 67 for those born later). But if you draw down funds from your IRAs

and other accounts to pay expenses while you delay benefits, there will be fewer of those assets left to tax when you file for Social Security.

Increasing your Social Security benefits will also allow you to reduce the amount you'll need from other accounts to pay expenses, Young says. That's a tax-efficient strategy because the maximum amount of your Social Security benefits that will be taxed is 85%, versus 100% of income from tax-deferred accounts. Vanguard Group offers this example of how delaying benefits could lower your taxes.

Scenario 1: Michael and Patricia file for benefits at age 62, with $51,000 in pretax income from withdrawals from tradition … from Social Security. Based on their earnings history at age 62, 85% of their benef… …eir after-tax income will be $69,693 and they'll owe $5,307 in federal taxes.

Scenario 2: Michael and P… until age 70. In between the year they retire and the year they file for benefits, they … …axable benefits from their IRAs to pay expenses. But when they file for benefits, … …40, which means they'll only need to withdraw $32,760 from their IRAs to generat… …nount of retirement income. Using the same assumptions (no additional income and … …n), only 34% of the couple's Social Security benefits will be taxable. Their after-tax i… …14, and their federal taxes will total $2,086. Although their total tax bill will be slightl… …before they claim Social Security benefits, the decline in their tax bill after age 70 w… in less than two years.

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4. MAKE Y… …E PORTFOLIO TAX EFFICIENT

Just as a tax-efficient investment portfolio can lower your overall tax bill, it can also lower taxes on your Social Security benefits. A taxable portfolio that generates a lot of income from dividends, interest or capital gains distributions will increase your AGI, which can in turn increase the taxes you'll pay on your Social Security benefits.

Consider using your taxable portfolio to invest in growth-oriented stocks or stock funds, which tend to be more tax efficient than funds that throw off a lot of taxable gains. As long as you hold the stocks or funds for at least 12 months when you sell they'll be taxed at the long-term capital gains rate, which ranges from 0% to 20%.

During bear markets, take advantage of tax-loss harvesting to lower taxes on your capital gains. Meanwhile, house your fixed-income investments that generate taxable income — such as corporate bonds, high-yield bonds and bond funds, CDs, and other taxable income-oriented investments — in your IRAs, where gains grow tax-deferred until you take withdrawals. While interest from municipal bonds is included in the formula used to calculate taxes on Social Security benefits, don't assume munis have no place in your overall portfolio, says Rob Williams, managing director of financial planning, at Schwab. Most retirees who invest in municipal bonds are already in high-income tax brackets, which means there's

a good chance they're already paying taxes on 85% of their benefits. In that case, muni bonds could reduce your overall taxable income, Williams says, because interest is exempt from federal income taxes and, usually, income taxes of the state in which the bond is issued.

How to pay taxes on your benefits

Once you determine that you'll owe taxes on a portion of your Social Security benefits, you'll need to make another decision: how you'll pay them.

The IRS provides a calcula timate the amount of your benefits that will be taxable. You'll need the amount of its from Box 5 on Form SSA-1099, which Social Security mails out to beneficiaries i the amount of income you receive from other sources, such as wages, pensions an long with any interest you earn from municipal bonds. You can arrange to have ta ur benefits by filing Form W-4V with the Social Security Administration, by mailing st to your home.

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If you don't have taxes wit efits, you may have to pay quarterly estimated taxes to avoid underpayment penal wait until year-end to take distributions from their IRAs (and other tax-deferred acc ption. Taxes withheld from IRA distributions are considered paid evenly thr n if they're made in a lump-sum payment at year-end. You can ask your IRA provider o cover your estimated tax on the IRA distribution as well as taxes on your Social Se nn Reilley, a certified financial planner and certified public accountant in Charlotte, N.C. The advantage of this strategy is that you can continue to earn interest on your savings until the end of the year.

States that tax social security benefits

In addition to paying federal taxes on your Social Security benefits, you may have to pay state taxes on them. A dozen states impose some tax on Social Security benefits, but the way they tax benefits — and who they tax — varies.

- Colorado
- Connecticut
- Kansas
- Minnesota
- Missouri
- Nebraska
- New Mexico
- Rhode Island

- Utah
- Vermont
- West Virginia

In Colorado, for example, residents younger than 65 may owe taxes on Social Security benefits, but older residents are usually exempt. Other states tax benefits only if income exceeds a specified threshold amount. For example, Missouri taxes Social Security benefits if your income tops $85,000 (or $100,000 for married couples). Utah includes Social Security benefits in taxable income but allows a tax credit for a portion of the benefits subject to tax.

In response to complaints f the number of states that tax Social Security benefits is shrinking. Several states ar f budget surpluses to phase out taxes on Social Security or expand exemptions. Nebra tax on Social Security benefits over the next two years, and Colorado, New Mexic West Virginia have expanded exemptions and deductions for Social Security income

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Block joined Kiplinger in June 2012 from USA Today, where she was a reporter and personal finance columnist for more than 15 years. Prior to that, she worked for the Akron Beacon-Journal and Dow Jones Newswires. In 1993, she was a Knight-Bagehot fellow in economics and business

journalism at the Columbia University Graduate School of Journalism. She has a BA in communications from Bethany College in Bethany, W.Va.

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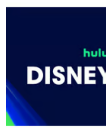

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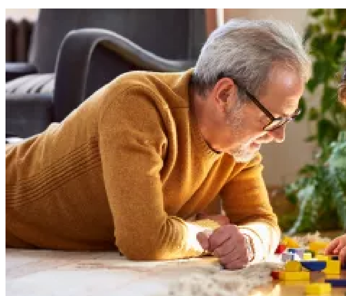

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