Episode 146 The Concept of the 'Tax Torpedo'

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SPEAKERS
Alex Murguia, Bob French, Wade Pfau

Bob French 00:00
The purpose of retire with style is to help you discover the retirement income plan that is right for you. The first step is to discover your retirement income personality. Start by going to risaprofile.com/style and sign up to take the industry's first financial personality tool for retirement planning. Social Security benefits are great, right? Well, until the tax torpedo shows up, let's see how Alex and Wade disarm it before it sinks. Your retirement plans.

Alex Murguia 00:51
Hello everyone. Welcome to retire with style. I'm Alex Murgia, and I'm here with my Daz boot commander Wade Pfau, as we talk today about the tax torpedo. Yeah,

Wade Pfau 01:08
you pulled in a world war two reference there with the torpedoes. But that's absolutely right, Alex, welcome everyone to the show Social Security taxation, how Social Security benefits are taxed. It's really the topic for today, and colloquially, it's known as a tax torpedo. So that's kind of the fun name we can give to the episode.

Alex Murguia 01:30
It's all hijinks here at retirement.

Wade Pfau 01:34
Yeah, I was thinking before we started, just where did that term come from? Not 100% sure, but when you look at a visual about the effective marginal tax rates as it relates to different income sources, you can see a spike in those taxes, and that's what the I think the origin of the term is how this torpedo is rising out of the income tax brackets to provide a lot of shock and awe to the person calculating their taxes When they're also a recipient of Social Security

Alex Murguia 02:03

benefits, hence, hence the name, no, well, that does boots. That's from, that's that, I don't know. Maybe it's an actual thing. You know probably more about history than I do. I was just referencing the a movie like in the early, early 80s, like a German

Wade Pfau 02:19
it's like a world war two German submarine movie, right? Yeah. It's about the extent of my knowledge there. I

Alex Murguia 02:25
think it's a wow, yeah, never mind. Let me just leave it at that. I have in my head. I know it's not Wim vendors or the guy who defits a corralda, but I just can't get it in my head. Who did it? So I'll just move on. People are here for retirement income planning advice, that's right, all right. So what are the ins and outs of the Social Security tax torpedo? Yeah,

Wade Pfau 02:49
yeah. Well, to kind of lay some context in this discussion, we're part of an arc. We're looking at tax efficient retirement distributions. Part of that can be front loading taxes in retirement before really getting into the mechanics of all that precisely just we want to cover some of the pitfalls with generating more taxable income. Now, this may be a pitfall that will hit you later, and it's actually a motivation to do the Roth conversions before you start Social Security. But one of the pitfalls is when you generate taxable income that can uniquely also trigger taxes on more of your Social Security benefits. And that's what we want to cover and really dig into. And it's something that's real. So recently, Peter coy at the New York Times wrote a blog on this topic that was read by a lot of people, and they turned the comments off after a couple days, but it had like 700 comments, and I talked to him for that article, so I was paying more attention to it. But some of the comments people were saying, this is just made up nonsense, or it's theoretical mumbo jumbo. It doesn't apply in the real world, and that's not true at all. This is really something that the middle class,

Alex Murguia 04:01
they were saying that to some of the strategies, or to the overall effect, that there is something as a tax torpedo that can take your legs out from under you, from an income perspective, if you're not careful.

Wade Pfau 04:12
No, I think it wasn't questioning the existence of the torpedo. It was maybe questioning more that anything could be done about it.

Alex Murguia 04:19
Oh, just, just take your fate and do

Wade Pfau 04:23
take your poison.

Alex Murguia 04:25
That sounds like an external locus of control,

Wade Pfau 04:30

right? But it's real, and it's we can't just talk about one tax torpedo, because it does vary based on the level of social security benefits, but generally speaking, married filing jointly. When you have non Social Security income, some again, it depends on your benefit, but between approximately 20,060 $1,000 of non Social Security income, adjusted gross income, that's when you're in the torpedo. So it's a pretty broad range. And when you add social. Security on top of those numbers, and we're really talking about middle class type retirees. And similarly, for single filers, you could probably go a little bit lower than 20,000 but then up to the 40, $50,000 type range can impact them as well, and that's their non Social Security income sources. So putting that together again, you've got a nice middle class retirement lifestyle that if you can help manage how much of your spending is from taxable income sources, you may be able to reduce the amount of Social Security benefits that are taxed. You'll be taxed on somewhere between 0% and 85% of your Social Security benefits when your income is still in the range where you're taxed on 0% of the benefits, the torpedo hasn't started, but it's you have to have really low incomes to be there. So that's tough. But then once you get to the point where 85% of your Social Security benefits are being taxed, which for married filing jointly, it's going to be somewhere in that again, it depends on your benefit, but 65,000 $70,000 range, then the torpedo ends, and it's no longer an issue beyond that point. Now we're talking about a broad range of income where it's applicable. So it isn't theoretical mumbo jumbo. This is something people really can plan around and have a significant impact on their taxes.

Alex Murguia 06:18
I think Wade just, just because I'm trying to imagine some folks may be listening to this for the first time. So there's some folks that are wondering. And we've done an arc on Social Security, where we discussed the feasibility of the trust fund and all of that, and we sort of set the record straight in terms of, you know, these dragons are manageable on many, many levels, but there's still somebody could be listening, thinking, so wait a second. Not only could Social Security be teetering, which is not but it's just the feeling they're gonna be saying, well, in addition to that, whatever's left, I can be taxed on 85% of it, if I'm not careful. Oh, my goodness. What? What? What would you say to that like, just from a visceral level, to those folks?

Wade Pfau 07:06
Well, yeah, I mean, a side discussion can relate to whether Social Security benefits should be taxed in the first place, that they were not taxed until 1983 and then, as part of the reforms that saved the trust fund at that time, up to half of the benefits could be taxed. And then in 1994 further set of reforms increased that numbered up to 85% so it's effectively a taxable income source, although it does get the benefit at least 15% of it's not taxed.

Alex Murguia 07:33
So is a cynic saying they've already cut Social Security significantly. You just don't know it. Yeah,

Wade Pfau 07:39
this is a so when we talk about social security reform, the idea of means testing comes up where making Social Security more like a a welfare program, where if your income exceeds certain thresholds, you wouldn't get a Social Security benefit that violates the whole history of Social Security that there wasn't supposed to be any stigma. This is an entitlement you contributed into the system. You receive a benefit from the system. So means testing may never happen, but then you do have stealth means testing. And simply taxing your Social Security

benefits is a form of stealth means testing. Right now, about half of Americans are paying some tax on the percentage of the benefits they pay tax on is greater than zero. That's for about half of people. The other half their incomes are low enough, and that's effectively, because they don't have any income outside of Social Security that they're not paying taxes on.

Alex Murguia 08:34
You're telling it. This is like the no spin zone for retirement income plan. No,

Wade Pfau 08:40
yeah. See how deep we can dig into this without becoming political. No,

Alex Murguia 08:44
nobody. You know, it's kind of funny, right? Like it's fair game for someone to be thinking, you know, we're paying attention to the wrong thing when it comes to what you're gonna stand for on Social Security, because by taxing it, it's just a backdoor means testing. It is an expensive way to do it too. Probably, yeah.

Wade Pfau 09:07
And there's other stealth means testing, things, just changing the benefit formula so that you get a lower replacement as your benefit gets larger, and that sort of thing. But,

Alex Murguia 09:16
but this affects a lot of things. You know, we're talking about retirement distribution planning, but this could also affect going back to work, you know, and keeping your income below a certain amount, etc, etc. Do you want to maybe take us through those calisthenics?

Wade Pfau 09:37
Yeah, yeah. I mean, let's dig into it. So since 1994 up to 85% of your benefit is taxed, and the thresholds for determining that were set in 1994 and it's one of the rare parts of the tax code that's not inflation adjusted. So when I say that 50% of Americans are not paying tax on their social security benefits, that. Percentage is increasing over time, just as those old thresholds don't get adjusted more and more income and as every year there's a cola on your Social Security benefit, it's just pushing people, over time to experience taxation on their benefits. The system is pretty complicated for determining how much of your benefits are taxed, so we can kind of walk through the highlights of it, but you really need to sit down to with some tables and charts to fully visualize things. Do

Alex Murguia 10:29
you suggest they watch this on point five speed

Wade Pfau 10:34
or listen to that might not be the solution. It's more than need something to look at but it's in 1994 they set these provisional income tables. They're not so big. It's either single filers, married filing jointly. Those are the standard ones, and it shows provisional income which has other names, depending on what you reading. It could be called provisional income, combined income, or total income. It's a theoretical number. It's not anything that shows up on your 1040 but it's your modified adjusted gross income, which in this context, pretty much means your adjusted gross income minus the taxable portion of your Social Security benefits or set another

way, it's your adjusted gross income just not accept not counting the Social Security part, plus half of the Social Security benefits for this theoretical hypothetical number plus. And this is another gotcha that it's worth definitely highlighting for folks who aren't aware of this tax exempt interest. So if you have muni bonds that the interest is not taxable, that's great, but you do have to add that interest into this provisional income measure, and that's also going to be true with the so with Medicare, Irma, that we'll talk about in a different episode, that so modified adjusted gross income, which is your adjusted gross income minus the taxable portion of your social security plus one half of the Social Security benefits plus tax exempt interest sources. That's your provisional income. And once that number gets above 25,000 for singles, or above 32,000 for married filing jointly, welcome to the tax torpedo. You

Alex Murguia 12:21
know, Wade, that's kind of a little circular as well. I don't know if you picked up on that. It's like, if this was, if you'd line item these on an Excel spreadsheet, and then you get a sum you get you you wouldn't, but it's almost sounds like you would almost get an exclamation point, because the half of the sell of half of the benefit is almost self referencing part of the modified adjusted gross, you know what I mean? Yeah, kind of funny. Not quite. But you know what I mean? It makes it circular a bit. Yeah,

Wade Pfau 12:50
I call it loopy. And then one of the comments in that, that New York Times piece, was saying, No, it's not loopy. And so then I had to get into Not, not actually, he wrote to the author too. So he was doing some fact checking, so we had to work through some of that. It's not

Alex Murguia 13:05
loopy after the first year. It's the first year baseline. That sounds like, Wait, okay, okay,

Wade Pfau 13:09
okay. Well, you don't, yeah, you don't know what your adjusted gross income will be until you know how much of your Social Security is taxed. You want to know how much is taxed, until you know how much you have to take out of your IRA to pay those taxes. But as you take money out of the IRA to pay your tax bill, that causes more of your Social Security to be taxed,

Alex Murguia 13:27
that's what I mean, like, there's a there's a, oh, but I know something you don't know. I am not left handed. You know that kind of thing.

Wade Pfau 13:38
Yeah, I don't know if the policymakers who designed, who designed these rules, could have thought of a more complicated way to to design it, but okay,

Alex Murguia 13:49
but bottom line, it's provisional income. What are the limits? Because it's, it's to your point, there's, there's a, there's a big swath of people that is going to hit. If you're

Bob French 13:58
looking for more personal advice. Take a look at this episode's sponsor, McLean asset management. You can learn more at McLean am.com that's m, c, L, E, A, n, a, m.com McLean

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Wade Pfau 14:27
Yeah, so the it's, it's really hard to make any sort of sense out of the limits that that provisional income table is small. It's, I already mentioned the well up to 50% of your benefits will be taxed for single between 25,030 $4,000 of provisional income, and then up to 85% is taxed for singles with over $34,000 of provisional income. For married filing jointly, up to 50% is taxed for between 32,040 $4,000 of provisional income. Income, and then up to 85% is taxed for over $44,000 of provisional income. But that's not really all that helpful. You can't really apply that to your 1040 those provisional income numbers are just these hypothetical numbers. As I was saying before, it's really depending on your benefits. This is going to be a problem for you, married filing jointly, until you're up to somewhere in the ballpark of $65,000 of taxable income. That's not social security, not counting the Social Security. Once you get beyond that level, it's no longer an issue. 85% is taxed, end of story.

Alex Murguia 15:38
And so even though we're talking about retirement income. This is why some people, you hear them, saying, I can only work so much. I don't want to work more than so many hours, because then it it, I lose any benefit over and above a certain amount because of the taxes on the Social Security. But that's on working with, you know, and trying to figure out, you know, bracket managing your income there. But yeah,

Wade Pfau 16:02
that's your adjusted gross income. So that's it. Roth IRA distribution. So

Alex Murguia 16:09
it also hits investments go on

Wade Pfau 16:11
anything out of your IRA goes directly into this, any work income goes directly into this, long term, capital gains, qualified dividends, interest off of your taxable investments all go into your adjusted gross income as well. So taxable accounts are generating qualified dividends and interest. You can't avoid that the IRA, especially after RMDs. You can't avoid the RMDs beforehand. Any money coming out of the IRA, it's, it's not a pleasant, uh, income source, like if I take $1 out of my IRA, and I'm in that part of the torpedo where $1 from the IRA is going to uniquely cause another 85 cents of Social Security to be taxed. It's like taking $1 out of my IRA expand my taxable income by $1.85 and so I'm paying taxes on $1.85 I took $1 out of the IRA. I'm not paying taxes on an extra dollar 85 that's kind of the intuition about why the tax torpedo is as it is. If I'm in the 22% bracket, that dollar out of the IRA causing 22% tax on $1.85 it's that changes. That's like a 40.7% effective marginal tax rate on the dollar I took out of the IRA. So that's what we're talking about here.

Alex Murguia 17:35
That's a great way of thinking about it. I just didn't want to get hit with when you framed it as any dollar I'm taking out of the IRA, it's really I'm paying $1.85 in taxes on it.

Wade Pfau 17:45

Well, my taxable income increases. Yeah, sorry, but, you

Alex Murguia 17:49
know, it does. It's an interesting way to frame it. And the other point, I would say, as I obviously, I'm looking at the table, but these are in when you look at your like, you know, your wage bracket, you know, it's pretty steady. And it's the first couple of one that you gap up, you know, quite a bit here, though, this table is very unforgiving in the sense of $1 let's say just doing the married jointly, $1 more than 32,000 and boom, you go from zero taxable benefit to 50% up to 50% of the taxable benefit. Yeah,

Wade Pfau 18:20
the up to is important. It's not that suddenly half of your benefits are taxed. It's that now $81 over the limit means 80, well, 50 cents of Social Security is now also being added to your adjusted gross income. Yes, that's and so then at that point, you're like, point 00, 5% of your benefits are being taxed. It's not immediately jumping to but

Alex Murguia 18:44
they're they're like, but they're the huge gaps. You know, I'm saying from 50 to 85 Sure, it's gradual, but it's like, these brackets are like, unforgiving, it seems to

Wade Pfau 18:55
me. Yeah, there it's gonna be smooth in terms of the percentage of your benefit that's taxed is going to gradually rise from zero to 85% over that range of income where the tax torpedo applies. All right, yeah, so if your mind is blown beyond that, like, what have we not really mentioned yet? Oh, well, I guess I mentioned an example, but it's probably worth digging in a little bit deeper too. So whenever I talk about case studies, and actually this will probably be a case study, we carry throughout multiple episodes, I usually if it's a married filing jointly couple, I'll say the high earner in the couple has a primary insurance amount of $3,000 a month, which would be 36,000 No, that's not what am I getting wrong, right there, 25 it's $2,500 a month would be which translates into per year, $30,000 Is as $2,500 a month primary insurance amount, if they delay until 70 that benefit is then 37,200 a year. If we assume that this is rare these days, but a couple with just one working spouse, so then the the spousal benefit would be 50% of the primary insurance amount, or an extra $15,000 a year. It gets the total household Social Security up to $52,200 a year after age 70, if that high earner delayed to 70, given that you just you look at what the ordinary income brackets are doing. You've got your 10% bracket, you've got your 12% bracket, you've got your 22% bracket, and so for a while, as you generate, like, we'll just make it simple, as you're pulling money out of the IRA first, you're filling up your standard deduction. But you don't get to have the standard deduction fully met through the IRA distribution, because as you're pulling from the IRA eventually you're going to enter the tax torpedo, and so a portion of your benefits will be taxed. And so you, you end up leaving the standard deduction and entering the 10% bracket sooner, before you fill up the the full, I mean, the standard deduction amount is going to include a portion of taxable Social Security there. Then once you're now your your adjusted gross income enters that 10% bracket. As you take another dollar out of the IRA, it's causing $1.85 to be taxed at 10% or an 18.5% effective marginal tax rate. And then, right now we're talking about married filing jointly. Then you enter into the 12% bracket. Take $1 out. It's going to be where, at this point you're already in that range where 85% is you're working up to 85% so 85 cents, $1 $1 out of the IRA leads to dollar 85 tax at 12% that's a 22.2% effective marginal rate. Then you'll leave the tax torpedo while

you're still in the 12% bracket. So you go back into the 12% effective marginal rate for a while, and then you just, you get to the the 22% bracket. You've left a torpedo. You're you're done with the torpedo at that point. So you're married, filing jointly, ignoring Social Security. You thought you're enjoying your standard deduction. You're going into the 10% bracket. Then you're going into the 12% bracket. But due to the tax torpedo, you start paying at an 18.5% rate sooner than you might have expected, and then you're paying at a 22.2% rate, and then you leave the tax torpedo, and you go back to 12% and this can get worse for singles, and that's it's called the widows penalty, or just singles get penalized, because most tax brackets in the lower income ranges double for married filing jointly. But if you recall those social security provisional income numbers, the singles weren't half of the double. That was 25,000 versus 32,000 single versus married filing jointly for when you enter into the the tax torpedo. So you end up as a single filer. You're still in the tax torpedo after you enter the 22% federal tax bracket.

Alex Murguia 23:34
Yeah, you can shoot. You can almost double that rate. Yeah,

Wade Pfau 23:38
yeah. But so then $1 out of I'm in the 22% bracket. I take $1 out of my IRA that uniquely triggers $1.85 to be taxed at 22% I'm paying 40.7% tax on that dollar I just took out of IRA. And that really looks like a torpedo, because that thing before and after it you're at well before it you're at 22.2% then you jump to 40.7% and that can happen. It depends on your benefit level. This is, I'm assuming this single person was a survivor. They got that age 70 benefit. So their Social Security is now $37,200 and then their non Social Security taxable income, once it gets to about $40,000 they're in that peak of the torpedo where they're at a 40.7% effective marginal rate. And that will last for about $8,000 of income. By the time they get to about $48,000 they finally leave the torpedo in this example, and they're they're in the 22% bracket, going further with Ira distributions. So really, once your income exceeds certain levels and so wealthier, like the high net worth, they're going to just be paying tax on 85% of their Social Security benefits. There's not really a whole lot they can do about it, but if you have some flexibility. In control about taxable income in these ranges, like this 20,000 to 60, $70,000 range, you can get some control over you're not going to probably be able to get your taxable portion of Social Security down to zero, but paying tax on 65% of your benefits instead of 85% of your benefits can be some real tax savings. Getting that number down to 50% instead of 85% can be some real tax savings. It's

Alex Murguia 25:27
wait. I think that's great. I'm wondering if it's worth mentioning, why the tax torpedo? Let's say take that single filer example that you were mentioning, and once they start crossing 37 and are way into 40,000 the rate jumps up right effectively, to on the on those amounts over by to 40% why will it go down? Because they may wonder, why doesn't it just stay up there? Why will it shoot back down? Once you know they get to the the income begins to cross 50,000

Wade Pfau 26:00
because once you leave the torpedo, I can take $1 out of my IRA. And since at that point, already 85% of my Social Security is taxed, it's no longer uniquely causing more of my benefits to be taxed. Already 85% is taxed. But as I was approaching there is like, I take $1 out of my IRA. Another 85 cents of Social Security is taxed. That is increasing the taxable portion of Social Security from like 83 to 84% another dollar. It's working its way up to 85% but once it gets there, it's over. You leave the torpedo and you are paying tax on 85% of your social security. But now

further taxable income is no longer uniquely causing more of your benefits to be taxable as well. They're already being taxed. And you've, you've you've got that covered, you've left it torpedoes over.

Alex Murguia 26:57
Mission accomplished.

Wade Pfau 26:58
Mission accomplished. So it's really it's only when you're somewhere between the zero and the 85% that it matters. If you're less than 0% being taxed, it doesn't matter if you're more than 85% being taxed or not more than but once you get to 85% being taxed, it no longer matters. It's when you're somewhere in between that your need you another dollar of income is uniquely causing more of the Social Security benefit to be taxed as well. And that's the tax torpedo in a nutshell.

Alex Murguia 27:32
Thank you very much. Wade and again, these were trying to hit up on in our arc on tax efficient distributions. We're trying to hit on potential snags that you will today we were dealing with a tax torpedo,

Wade Pfau 27:47
yeah, and this is actually the practical implication that this is not so much going to be a snag as it is a planning opportunity. Some of the other things we'll talk in this list are more like snags, like triggering Medicare surcharges. That's this one is more when we did the social not triggering the torpedo. Yeah, not, well, setting up so that you don't trigger the torpedo. Okay, there we go, like when we did the Social Security arc. I really argue in favor of at least for the high earner and a couple to delay to 70, or at least to consider delaying. And that argument is based on the longevity protection of Social Security. It's not based on taxes. But when you overlay tax efficiency on top of the Social Security claiming decision, what it really means is, if I delay until 70 and I'm retired already, like, let's suppose I retired at 62 I'm deciding, should I just claim at 62 since I'm retired, or should I delay to 70? Well, if I claim at 62 not only will I then have that lower lifetime benefit, but it's going to be a lot harder to avoid paying tax on 85% of that throughout my lifetime, whereas if I delay to 70, and I take that opportunity to do Roth conversions in the meantime, I might be able to bring that IRA balance down, get a lot more of that into the Roth IRA, which provides a flexible spending source that doesn't go into adjusted gross income, and uniquely, be able to not, not only will I have a larger benefit after age 70, but I might be able to get things set up so I'm only having to pay tax on, say, 40% it's hard to get it to zero, but say 40% of my benefits are taxable, instead of 85% of my benefits are taxable. Well, that's depending on the benefit level. Could be 15, $20,000 that's staying out of the adjusted gross income. So it can have, if you're in the 22% bracket, or whatever the case may be, you can have some real tax savings there. This is, there's real implications. And so this is, it is a snag. Having more income can trigger the tax torpio and. But in practical terms, what it's really pointing out is avoid the torpedo by doing tax planning before you begin Social Security benefits. Agree, all right, easy peasy. We've really covered the tax torpedo. Yeah, no,

Alex Murguia 30:20
I have nothing more to add other than more to follow with other strategies in the coming episodes. And we will also pepper this with advisors and real world scenarios, just so you can

sort of envision yourself going through them. Alrighty. Thank you everyone for listening, and we'll check us out next week on retirement style. Thanks,

Bob French 30:41
everyone. Wade and Alex are both principals of McLean Asset Management and retirement researcher. Both are SEC registered investment advisors located in Tysons, Virginia. The opinions expressed in this program are for general informational and educational purposes only, and are not intended to provide specific advice or recommendations for any individual or on any specific securities to determine which investments may be appropriate for you, consult your financial advisor. All investing comes with a risk, including Risk of Loss past performance does not guarantee future results. You