Human-Centric Investing Podcast

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Episode 25, Social Security: How will my benefits be taxed?

Host: John Diehl, John Diehl, Sr. Vice President, Strategic Markets, Hartford Funds

Featured Guest: Michael Lynch, Managing Director, Strategic Markets, Hartford Funds

Female: This is the Human-Centric Investing Podcast with John Diehl, where we look at the world of investing for the eyes of our clients. Take it away, John.

John Diehl: Hello, financial advisors. This is John Diehl, Senior Vice President of Strategic Markets at Hartford Funds. Welcome to episode 25 of the Human-Centric Investing Podcast. Joining me today is Mike Lynch, Managing Director of Strategic Markets here at Hartford Funds.

Welcome, Mike—it's great to have you back.

Michael Lynch: Hey, John. Thanks very much for the time—appreciate it.

John Diehl: So we're continuing on with the topic of Social Security because it always seems to come up. In past episodes we've discussed timing and filing strategies, but today we're going to focus a little bit on the general area of taxes.

While this may not be the most interesting aspect of Social Security planning, it's important because like timing and working, taxes are one of the factors that can reduce Social Security income, even if sometimes it's kind of hard to figure out how.

I will also tell you, Mike, that taxes is one area I think you'll agree that fires up a lot of our clients, because I think their thought was, "Look the Social Security benefits that I've earned, were earned, through taxing me, and now you're telling me that my Social Security benefits might actually be taxable."

And I think helping people to understand how that happens, I think is important just so that the educated client can keep things in perspective. So Mike, with that are you ready to help me break things down for our audience?

Michael Lynch: I'll certainly try my best, J.D.

John Diehl: All right, so let's get going. First Mike, would you tell us when Social Security benefits are subject to taxation? Is it from the first dollar I receive, or how does it work?

Michael Lynch: Yes, well the way they calculate—and I think you're exactly right. I travel the country as you do and we do seminars and boy, it gets a little uncomfortable when we get to the slide and we talk about taxation because I think you're right, I think folks hadn't really thought about that... didn't really realize that maybe a portion of their Social Security benefit's taxable.

So the way it's calculated is, first take a look at their modified, adjusted gross income and usually I get some puzzled looks in the crowd. And I say, "Gosh, let's make sure we're working with a tax professional first. Let's try not to figure that out on our own."

But your modified adjusted gross income, we're going to have to add back in any tax-free income which kind of adds insult to injury to some extent.

Then on top of that we have to add back in half your Social Security benefit so if you're taking—say you're collecting $2,000 a month/$24,000 a year. Half of that $12,000 is going to be added back in and added to that modified adjusted gross income number.

Then based on that number, that's going to equal what they call your combined or provisional income. And then depending on where that's at you may not pay taxes on your Social Security benefit, or you may pay taxes on a portion, or you may pay taxes on a large portion—a substantial portion.

So the first step is really that calculation, and again hopefully they're working with a good, qualified tax advisor or their financial advisor knows that those numbers are. But then based on that they'll go in to these three brackets.

John Diehl: So Mike, can you give me an idea of kind of where the caps are?

Michael Lynch: Sure.

John Diehl: Maybe we'll just take one example if you have the numbers in front of you. Let's take somebody that's married and filing jointly, right, because that's kind of a fairly common thing. At what level will I not be taxed at all on any Social Security benefits that I'm receiving?

Michael Lynch: So sure. So married, filing jointly, you come up with that combined income number. If it's less than $32,000 then none of your Social Security benefit's going to be taxable. However if you're—I'm sorry, go...

John Diehl: Yes, and then what's the—and then there's other brackets right behind that. What would the next level be?

Michael Lynch: Two others.

John Diehl: Okay.

Michael Lynch: Two others today. So $32,001 to $44,000: that gradually would go up to 50% of your Social Security benefit will be taxable. Now usually we hear a thud in the crowd and sometimes people pass out, because they think it means you're in a 50% category or a 50% bracket.

That's actually not what it means. What it means is half that Social Security that you're receiving is going to be subject to taxation at your current tax rate.

Now if we're currently working and we haven't filed for Social Security, we don't know what that number is, right? We may know what it is today, maybe 20-25%, but we don't know in the future.

I'm 54. I don't know what that benefit—where that tax number is going to be 10 or 15 years from now. But we do know the calculations so up to 50% of that would be subject to taxation at that current rate.

So again, $24,000 a year... $12,000 of that would be subject to taxation. You'd have to pay taxes on $12,000 at that current rate and again, maybe that's 20% or whatever that number is. And then last but not least, if you're over $44,000, married filing jointly, up to 85% of that is going to be subject to taxation at that current rate.

Now the challenge is those numbers are very small if you're working part-time, if you have some rental income, if you're over 70½ and you've done a good job with the IRA, but you've got to start taking your requirement of distribution.

So many of our clients that have done well, saved for retirement, continue to stay active, maybe continue to work part-time/full-time. They're probably going to be in that third category very, very quickly, unfortunately.

John Diehl: And so Mike, just to kind of take a step back and review that...

Michael Lynch: Sure.

John Diehl: I heard you say that it's kind of a gradual approach in-between those brackets, so it's—so if I'm understanding you right, it's not like as soon as I'm married, filing jointly and I hit $33,000 of income that automatically 50% of my Social Security benefit becomes taxable, right? It's kind of a—it's a function of that calculation that you talked about, right?

Michael Lynch: Exactly, yes. Just like from a tax level it's notcit's gradually building up to that. So that the max would be up to, the max would be 50% if you're right at that $44,000 level. If you're more down to the $33,000 or $34,000, then certainly the percentage is going to be a little bit lower.

John Diehl: So Mike, I think that you used the terminology, and I think it's right that up to 50% or up to 85% of benefit—of a Social Security benefit can be taxed. It's not that people are in a 50 or an 85% tax bracket, but it's up to that amount of their benefit could be taxed.

I think that's one of the most common mistakes I hear people making. So let's turn the corner a little bit, Mike. Let me ask you about working because there are a lot of boomers who are currently receiving Social Security benefits who are still working and earning income. Should they be cautious?

Michael Lynch: They should. I mean, it depends if they're continuing to work full-time; they're making a nice living, they're going to continue to make a nice living.

They maybe want to be aware of the fact that their benefit may actually be reduced, and in some cases may be dramatically reduced if they continue to work at say 62-63, making a good living and file for the Social Security benefit.

So for example, if I'm 62 years of age, I'm concerned about Social Security. I want to turn on my Social Security benefit but I'm making $30,000, $40,000, $50,000 a year.

My benefit may be dramatically reduced because today the cap is $16,920, so the idea behind that is I can file for my Social Security as early as 62, continue to work—maybe I'm working part-time three days a week or something.

If I make less than that cap then I'm fine. My Social Security benefit's not going to be reduced. But if I literally go to $16,922, I'm $2 above; my Social Security check goes down by $1.

Another $2 above, it goes down by $1. So rather than scratch your head and kind of do the math what we tell folks is if you're making $30,000, $40,000, $50,000 a year, your benefit may be reduced in half if not even larger than that. So it becomes a challenge.

Now the year that you turn full retirement age, so my full retirement age is age 67. I'm on the fence and I think, "Gosh, that year that I turn 67 I'm going to file early. I'm going to file knowing that I'm going to reach full retirement age sometime this year." The cap is still in place but it's a little higher, it's $44,880.

Now if I go over that cap by $3, they draw down $1. Another $3 they draw down $1. So it's not to say it's a penalty, but I always think in the back of my mind, to some extent it's a penalty or an incentive basically not to file early and continue to work.

The good news is at age 67 in my case, or 66 and two months—I have a client out that's full-retirement and 66 in two months. Once they reach full-retirement age they can earn $1or they can earn $10 million—their benefits not reduced. It's only prior to full retirement age that their may be a benefit reduction.

Say you've got a client that retires at 67, and a couple of months in o it says, "You know what, this isn't right for me. I'm going to get a job driving Uber, or I'm going to discover some product..." whatever it is, going to go back and consult.

They can earn an unlimited amount of money. It really doesn't matter—their benefit's not reduced. It's only prior to full retirement age if they file and continue to work that we need to be aware of this cap. And it's truly just your earned income, but again those caps I think you'd agree are pretty low unfortunately.

John Diehl: So Mike, I think it's important for people to realize—now I know there's a mechanism where if your benefit is reduced that eventually you would be repaid some of those lost benefits, so it's not like you lose them forever. But in theory the reason why people are filing early is because they want the cash flow, and in this case exceeding those income limits would reduce that current income flow, right?

Michael Lynch: Yes, exactly. I always think of it as kind of insult to injury, right? So I file early, I'm getting a reduced benefit and then, gosh, a couple of months in I get a check and it's even lower and gradually it goes lower and lower because I need to continue to work.

So that's where it really becomes an opportunity to sit down and say, "Before I do anything, do I really need this income knowing the fact that if I continue to work it may not be $800 a month? It may in fact come out to $200 a month."

Now does it really make sense because I may get that money back once I turn full retirement age, but I have also still filed early?

So I'm always going to be at a lower dollar amount than a friend, a relative, or a neighbor regardless of what happens in the future, because I took some action at 62 as opposed to potentially waiting.

John Diehl: So Mike, one thing I want to go back to, which we talked about kind of at the beginning of this podcast. was this concept of modified adjusted gross income. And I just want to make sure that I heard you right, because as we're determining how much of our benefit is taxable, did you say that tax exempt income is included in that calculation?

Michael Lynch: Yes. That's included in the modified adjusted gross income, so that's kind of again adding insult to injury isn't it?

John Diehl: Yes, unfortunately. It's kind of, "When is tax-exempt income not tax-exempt," right?

Michael Lynch: Yes. It's not that you pay taxes on that, but I guess indirectly it's used in that calculation which always concerns me, because as generally as we get a little bit older we start to think more conservatively in our investments. And sometimes being too conservative may actually impact this negatively.

So that's where I think the value of the advisor is so important to say, "Let's look at our investments today and there may be an opportunity to think about some different ways than best—and be a little bit more diversified where it actually does help them down the road from a tax perspective." But instead of trying to scratch your head, I always encourage folks let's talk to our tax person.

Let's get a team of people in place before we do anything. Just because I read on the internet or I saw something on TV, or I went to one of these things that says, "Hey there's a million different ways to choose or elect…" That's great. That's all hypothetical information. I want to sit down and talk to somebody who knows myself, knows my wife, knows my kids and knows really what I'm trying to accomplish.

Sometimes it's tough to explain, but I think if you have the relationship with someone, they can kind of understand and say, "All right. Here's your position. Do you really need that money knowing some of the negatives?"

Now again, there's no right or wrong; the client needs to sleep at night. Maybe the client has some intention for some of that money. They're just adamant that that's the option.

There's no right or wrong, but I think the key is really educate them as to what their options are and put them in the best position to say, "Okay, I'm comfortable. I know there's some negatives, but there's also some positives to my option so I'm going to choose that option."

John Diehl: So Mike, sometimes when we talk about… I guess I'm trying to think about how advisors should help clients from a general approach to Social Security taxation, right?

Because many times I'm sure you're approached by clients or advisors who have clients who have a pension and are still working, and they have a considerable amount of income still coming into the household.

You talked about those levels for example: married filed jointly at $32- and $44,000. You're not going to tell someone to stop working just so they can avoid Social Security taxation, right?

Michael Lynch: Right, right.

John Diehl: Kind of, how do you approach this question about taxation in general? How can people potentially reduce the amount of benefits that are subject to taxation if they even have that flexibility?

Michael Lynch: Yes, it's probably something that we do on an annual basis, right? I know I talk to my CPA every year about ways to reduce my taxation and nothing is ever positive, unfortunately.

But I think, in this case I think there's an opportunity to say, "Let me think about my sources of income and retirement. Am I receiving some money from pension as you mentioned? Am I receiving some money from Social Security and to fill in the gaps? Where am I taking money from a personal standpoint? Is it my 401(k)? Is it an after-tax account?"

And one option in particular—and it's not right for everybody—but it may be an opportunity as an advisor to just maybe reeducate clients and the option of a Roth IRA.

So if the client has some money in a Roth and needs say $200 a month, the good news today is when you think about that calculation as we mentioned before, the good news is the Roth IRA, that $200 a month, would not be includable in that calculation.

Or if I had money in my 401(k) but in the Roth option of my 401(k), and I start drawing down that option. Again, that would not be includable... so maybe a tax-free loan from a life insurance company if they offer me something on my life insurance policy.

But barring that, there really isn't much that you can do but I think, thinking about that and saying, "How do I get into this option the most efficient way possible from a tax perspective?"

Again, it doesn't mean we want to convert all our money to a Roth IRA but for the right client, the right situation, at least sitting down and talking about that and saying, "Let's think about diversifying from a tax perspective prior to filing for Social Security to put us in this position to really think about ways we can minimize from a tax perspective."And I think as we mentioned some of those—the numbers are so low that there may not be anything you can do.

Again, when you turn 70½ and you have to start drawing down your IRA through an RMD, for some of our clients that are blessed. They're RMD may be close to that amount, let alone everything else.

So for those that are close to it I think it's an opportunity to have a conversation, but I think advisors at least knowing what the options are; is there anything that we can talk about?

Are there any things that we can kind of think about from a planning perspective that can maybe put us in a little bit better position? Again, for some clients, there may not be anything we can do but just having that knowledge base I think is important.

John Diehl: Yes, I think that's right Mike. I think clients can look at their income sources and say, "Which ones really can't I change?" Things like employment income, for example. Again it would kind of be shooting yourself in the foot to say, "Why don't I give up my income to see if my Social Security benefit's taxed." That's a little bit ludicrous.

Your pension income, for example is something that's pretty inflexible. But maybe on the margins when you look at where you're pulling discretionary income, if you would, maybe there is something that could be done with a Roth or something like that that may save a few bucks.

I think generally speaking though, what we find is that usually we're more in a position about educating people about why they're being taxed; what they are, whether or not there is any flexibility in terms of what they can do. I think they're at least grateful that the advisor and it works with the tax professional at least, to help them understand what they're being taxed on, right?

Michael Lynch: Right, exactly. I think that puts them in a better position. They're more comfortable after that as well.

John Diehl: Well, and connected to that Mike is obviously even what we talked about today; this area of taxation is kind of tricky and advisors have to be careful that they don't get caught in a position where it looks like they're kind of sorting this out on their own. In addition to things you already suggested, what do you usually suggest to advisors as they provide guidance to their clients on this topic?

Michael Lynch: Again, I think it's kind of the summary of what I've mentioned. I think it's an opportunity to have a conversation; think about the source of income at retirement. Really sit down and say, "Okay, SSA or Social Security is one portion of it, but what are our other sources of income? Let's do an inventory. Let's do a check up and just make sure we understand where everything is."

Because the last thing you want to do is get surprised by, "Oh gosh, I forgot to tell you about that account years ago I had with a friend of a friend," and that negatively impacts everything. Because the client is going to look at the advisor and say, "How am I in this position now?" Well, it's because we never knew about it.

So I think the opportunity to have an honest and open conversation—let's think about consolidation. Let's think about at least exploring and identifying all our sources of income at retirement; how those work together.

It's worth having that conversation and again. I would include the tax person in that conversation, too. If I do this, what happens? If I do that, what happens? One of the things I always try and compare Social Security to, John, in a seminar is I'll ask people in the meeting, "Who here is a recipient of a pension?"

And the numbers are getting lower and lower. Years ago you see everybody raise their hand. Now it's certainly far less. But I ask those people that are receiving a pension to probably think about the opportunity with a pension.

They probably have done some math behind the scenes, whether it's an online tool that's available or sitting down and talking to somebody saying, "When should I take my pension benefit, and what's the best benefit for me?"

I think you want to think about Social Security exactly the same way. Put that same work, that same investigation time into your Social Security just like a pension and say, "What's the best situation for me? What's the best situation for my spouse? "

John Diehl: Well Mike, I think in addition, I know you mentioned kind of reaching out to the client's tax advisor, but maybe another thing an advisor can do is kind of put together a couple different ideas in taxes that always seem to be a sticking point with their clients, and then use that as an outreach to local tax advisors to say, "Hey, I know we haven't done a lot of business together, but I have a lot of clients that are confused around the area of Social Security benefit taxation." Or if there's some other tax situation that is common to an advisor's clients, and being able to reach out to local professionals to say, "Would you be open to my giving you a call sometime if I have a client that is concerned about this, so that maybe you could help them out as well and we could work together with these clients?"

So in a way, looking at this area of taxation and looking at the need for an outreach to a tax advisor, it might make sense to build that circle of influence, if you would, with local professionals. Wouldn't you agree?

Michael Lynch: Yes, I totally agree. And that way, you kind of become the go-to team in the area. I think it's a great opportunity and maybe it furthers itself to doing seminars down the road and partnering up.

Yes, I think it's—I think the need is there. As we do seminars around the country, we find that most folks don't really know some of this stuff. So I think the need is there, and with the numbers growing as boomers—more and more boomers entering that next phase—the need is just going to be greater and greater.

John Diehl: So Mike, our time together is about to end. But before we discontinue, are there resources that can help advisors and clients in the areas that we talked about today?

Michael Lynch: Yes, I think a number of them. Ssa.gov is a go-to resource for me. I think they do a phenomenal job. I think with Hartford Funds we've got some great tools and resources on our website.

Hartfordfunds.com/ss. We've got some—there's a seven-question brochure that we've developed; common questions that clients ask. And then more importantly, there's a great workbook that advisors can share with clients that kind of go through an exercise and what's great about the work book is very high level.

I think sometimes these things get too intense where we're struggling with different numbers. This is a great opportunity to think about your source of income or retirement.

What are you thinking about from a Social Security perspective, and then put them in the best position going forward to kind of go through the exercise and say "Okay, I'm a little more comfortable now."

I think any of these conversations too, John—it's really the beginning of a conversation. It's rare that you'll meet somebody; you'll talk to them for 10 minutes and then they're fully prepared for Social Security or fully prepared for the next phase.

I think it really is an ongoing conversation and knowing that and saying "Okay, maybe a little bit at a time. Let's begin the process. Let's begin the conversation." But I think having those tools and resources at your availability—and I think one of the best resources advisors have is their existing clients.

It's a great way to build up that knowledge base in your book to say, "Next time I talk to someone who's maybe approaching Social Security, you can start to think about 'Gosh, Mr. and Mrs. Smith, they're a similar situation to the people I'm talking to now.'" Here's why they chose Social Security. Here's why they chose the age that they did. And here's what made sense for them.

Now it may not make sense for that person, but I can think of that as that knowledge base behind the scenes scenes, and use that resource to my advantage to say, "Here's some clients in the area that are a similar situation. And here's why they did what they did. Again, let's talk about the pros and cons."

John Diehl: Well that makes a lot of sense, Mike. And hey, I want to thank you again for being with us today.

Mike Lynch: Thanks John—appreciate it.

John Diehl: And again, the resource site that Mike mentioned with Hartford Funds is our website, hartfordfunds.com/ss. Again, hartfordfunds.com/ss. From all of us at Hartford Funds, we want to thank you for listening. We will talk to you again soon on our next episode of the Human-Centric Investing Podcast.

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