COORDINATING IRA DISTRIBUTIONS WITH SOCIAL SECURITY INCOME

By Thomas W. Batterman

Selecting an improper IRA distribution strategy for individuals eligible for Social Security benefits can dramatically increase tax liabilities. While you can't control the amount of your Social Security benefits, you can control how much Social Security you elect to pay tax on by careful management of your IRA distributions.

John and Mary Jones decided to take it easy that first year when they were required to start taking distributions—easy on the IRA, that is. Although they could have safely withdrawn as much as $35,000 in annual distributions without endangering their savings throughout their retirement years, they instead withdrew only the minimum they were required to distribute—$15,625. Their thinking, a common misconception, was that they could save themselves some extra taxes the following year.

Unfortunately, the Joneses would have been better off withdrawing a larger amount. As they were drawing out the minimum distribution, the value of their IRA continued to grow. The Joneses' distribution amount was not even covering the interest earned each year by the account and had not begun to touch the ever-growing principal, so their required minimum distributions were becoming larger each year. Ten years into their distribution plan, their required minimum distributions more than doubled, and the Joneses had to pay $25,188 in taxes on their Social Security income as a result. They could have paid less.

The Smiths, by contrast, had much the opposite problem. They took an annual distribution of $25,000 on their account that was worth $250,000. Unlike the Joneses, the Smiths found themselves heavily taxed on their Social Security immediately—approximately $6,050. With a distribution plan more properly designed for the income and Social Security situation, the Smiths may have been able to reduce or even completely eliminate taxes on their Social Security benefits.

While many people are not aware of it, improper selection of an IRA distribution strategy for individuals eligible for Social Security benefits can dramatically increase tax liabilities. While an individual cannot control the amount of their Social Security benefits, that person can control how much Social Security they elect to pay tax on through control, where possible, of other income and by careful management of their IRA distributions. This can be achieved through careful education and planning for distribution management.

SOCIAL SECURITY TAXATION

The first step toward a reliable distribution plan is understanding the problem.

Once an individual begins receiving Social Security benefits, the tax consequences of the Social Security benefits can range from being completely tax-free to having 85% of the Social Security benefits received subject to tax. Where a person falls within this taxation spectrum depends upon the determination of what the IRS calls the individual's (or couple's) modified adjusted gross income, or MAGI.

MAGI determination is a special calculation that adds together most

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income, whether taxable or tax-exempt (but specifically including otherwise tax-exempt income items such as municipal bond interest), and 50% of Social Security benefits received. The relationship of MAGI to certain IRS-mandated levels determines what portion, if any, of Social Security is subject to income taxation. Here are a few guidelines:

- The base amount is $25,000 for a single person and $32,000 for a married couple filing jointly. If MAGI is below these levels, Social Security is completely tax-free.
- If the total MAGI is above the base amount, but not above $44,000 (joint return), or $34,000 (single), either 50% of the excess over the base amount, or 50% of the Social Security benefits, whichever is less, is included as taxable income.
- If the total MAGI is above $44,000 (joint return) or $34,000 (single), up to 85% of Social Security benefits are included as taxable income. [For more information on taxation of Social Security benefits, see IRS Publication 915.]

BASIC IRA DISTRIBUTION RULES

Since IRA distributions are included in the calculation of MAGI, they can be an important factor in determining how much tax is paid on Social Security. Before examining options with respect to that impact, it is critical to recall a few of the basic IRA distribution rules and how they are related:

- An IRA beneficiary may, but need not, take distributions from their IRA without penalty after 59½ and before age 70½.
- At age 70½, an IRA beneficiary must begin taking distributions from an IRA. The minimum amount that must be withdrawn in the first and all subsequent years is determined by taking the year-end market value from the prior year and dividing it by a life expectancy factor. The appropriate life expectancy factor is based upon irrevocable elections the IRA owner makes in the year they turn 70½ and is determined with reference to an IRS chart. The life expectancy is usually a number, in the first year, between 16 and 25. Regardless of the distribution elections made, the life expectancy factor decreases each year. [For more on required minimum distributions, see the three-part series, "Beneficiary Designations and Required Minimum Distributions" by Clark Blackman and Ellen Boling, in the April, June, and August 1998 issues of the *AAII Journal*, available on the AAII Web site at www.aaii.com. Life expectancy tables for various ages can be found in Appendix E of IRS Publication 590.]
- The minimum distribution calculation only determines the minimum amount that must be withdrawn in a year. If the distribution is less than the minimum amount in any year, a tax penalty of 50% of the under-distributed amount is owed. What is important, however, is that the beneficiary may take out any amount that exceeds that minimum at his or her option without penalty, but subject, of course, to income taxes.

Because the initial life expectancies used in the calculation—typically in the range of 16 to 25 years, as mentioned before—are so high, the minimum distribution amounts in the early years usually do not withdraw all of the IRA's income, as in the case of the Joneses. In other words, on an IRA portfolio of $100,000 and a life expectancy factor of 25, the minimum distribution would be $4,000 or only 4% of the IRA balance. To the extent the portfolio earned more than 4%, the IRA would experience a growth in its value that year.

The result of increasing IRA values in the early years and the decreasing life expectancy factor each year is that the required minimum distribution amount continues to increase each year, since dividing the growing balance by an increasing smaller life expectancy increases the resulting required distribution.

SOME EXAMPLES

To fully evaluate the impact of a particular distribution strategy on your lifetime tax bill and your lifetime taxable Social Security amount, it is necessary to project your income and portfolio performance for an extended period of 15 years or more. However, to quickly assess how IRA distribution rules, working in conjunction with Social Security guidelines, impact an individual's taxes, consider the following examples:

- *Example 1*: Other income (including IRA distributions) is $25,000 and Social Security is $22,000. The MAGI is $36,000. Thus, $4,000 of Social Security (excess of $36,000 over $32,000 base amount) is taxable for a couple.
- *Example 2:* Other income (including IRA distributions) is $35,000, and Social Security is $12,000. MAGI is $41,000. Thus, $6,000 of Social Security (or 50%) is taxable for a couple.
- *Example 3*: Recall that if MAGI is greater than $44,000 (or $34,000 for a single person), up to 85% of Social Security is taxable. So if other income (including IRA distributions) is $41,000 and Social Security is $22,000, $17,000 of Social Security is taxable.
- *Example 4:* If other income, including IRA distributions is $20,000 and Social Security is $20,000, Social Security is tax-free for a couple.
- *Example 5*: IRA distributions are $10,000, other income is $22,000 and Social Security is $20,000. In this case, $10,000 of Social Security is taxable for a couple.

It is important to note here that if the beneficiary in Example 5 were under 70½, there would be no obligation to take an IRA distribu-

tion. And if no distribution had been taken, Social Security would have been tax-free. So the marginal tax rate on the $10,000 distribution that was elected was actually double the *normal marginal rate.* For example, if the person was in the 15% bracket, he pays 15% in taxes on the $10,000 distribution plus 15% on the taxable portion of Social Security that was otherwise tax-free. So this $10,000 distribution increased the individual's taxes by $3,000. This 30% effective rate on the $10,000 distribution is double the normal tax rate of 15%. Under proper circumstances even the 28% normal rate can be doubled.

The conversion of tax-free Social Security into taxable income by taking imprudent distributions amounts from your IRA is something I refer to as the Social Security "Supertax." To further see the impact of the Supertax, we can revise the numbers presented in Example 5. Instead of a distribution of $10,000, let's say the IRA owner takes out a distribution of $25,000. This pushes the MAGI above $44,000, making $17,000 of Social Security taxable.

However, you can control how much tax you pay on Social Security in many instances by controlling your IRA distribution strategy. If you follow a minimum distribution strategy, which results in ever-increasing required distributions as you get older, you may eventually, and needlessly, lose complete control over the taxability of your Social Security income and lock yourself into paying tax on the largest percentage of Social Security all of the time.

REVIEWING YOUR SITUATION

Not everyone faces the situation discussed here. But many retired people are not even aware that they may be facing unnecessary taxes. If your personal situation nearly resembles any discussed in this article, it behooves you to avoid the temptation of easy answers (just take the minimum distribution) and carefully assess all available options. Whether or not this problem affects you will be determined by three primary factors:

- Your level of Social Security income;
- IRA factors—size, your age, distribution election, IRA investments; and
- Your other income.

If a 10% IRA distribution, together with your other income and half your Social Security income, does not amount to the MAGI base amount for your filing status, you need not be concerned about this situation. If your other income and the minimum IRA distribution take you well above the upper limit for your filing status, you can still employ strategies to decrease your total taxable Social Security income, but you will always pay tax on a disproportionately high percentage of your Social Security compared to others. However, if you are between these extremes, proper planning can save you substantial taxes.

While it is impossible to cover every scenario in which you might find yourself and in which proper distribution planning could save taxes on your Social Security, here are some common situations and strategies to consider to reduce Social Security taxation:

You are taking more than required out of your IRA at present. If you have a smaller IRA and are taking money out of the IRA that you don't really need for living expenses (and if you aren't doing this based upon a previously well-developed strategy), you may be paying needless tax on Social Security benefits that diminish what you are earning. Consider reducing your distributions. Let's review our earlier example of the Smith family to further understand this concept.

- *Example 6:* The Smiths, age 65 and with a $250,000 IRA, began taking distributions from their IRA of $25,000 for living expenses. Because they were under age 70½, they were not required to take any amount at all from their IRA. They were receiving $15,000 in Social Security income and $7,000 in other income. Their taxable income was $39,500 (consisting of IRA distributions plus other income added to half of Social Security benefits). After subtracting deductions and exemptions, this couple paid $3,850 in federal taxes and $2,200 in state taxes. To reduce the amount of taxes paid, the couple should decrease the amount of the IRA distribution by $7,500. This $7,500 reduction in the amount of their IRA distribution would drop their tax bill from $6,050 to $2,200, for a tax savings of $3,850. This means the effective tax rate on the extra $7,500 they were taking out of their IRA was $3,850, primarily because of the Social Security Supertax. The couple determined they could live without the extra $7,500 in IRA distributions to save $3,850 in taxes.

You are taking, or planning to take, minimum IRA distributions. Individuals, especially those with larger IRAs, should not automatically assume that a minimum distribution strategy is the best plan. You need to project your IRA distributions based upon your distribution election and your projected IRA growth. Table 1 shows examples based on three distribution strategies (the first is a minimum distribution strategy, the worst choice in this example) and several other assumptions including an IRA starting amount of $250,000, and an 8% rate of return for the IRA investments). As in Table 1, this projection should account for your other income and determine the point at which you begin paying taxes on your Social Security; when you begin paying taxes on 85% of your Social Security, you should take steps to try to decrease your taxable Social Security

amount. To accomplish this, consider these ideas:

- *Don't wait until 70½ to start withdrawing.* Instead, consider taking distributions immediately after you retire and before you reach age 70½. By taking money out of your IRA during your post-59½ and pre-70½ years, you can dramatically reduce the amount of IRA you will be required to take out later in life.

On the other hand, you should be careful not to withdraw too much and incur needless tax on Social Security during this period, as discussed in Example 6. If you are fortunate enough to be able to retire without needing to be eligible for Social Security right away, this window prior to Social Security eligibility can provide an excellent opportunity to take money out of an IRA without current concern about the Social Security Supertax. Carefully controlling distributions early can keep your taxes down while keeping you in control of Social Security taxation later.

- *Review your investment strategy.* You also can review your investments and how they impact the growth of your IRA. Under previous laws or while you were working, it may have been best to

TABLE 1. IRA DISTRIBUTIONS AND SOCIAL SECURITY: TAX ANALYSIS EXAMPLES

Age	70	71	72	73	74	75	76	77	78	79
Social Security Amt ($)	20,000	20,000	20,000	20,000	20,000	20,000	20,000	20,000	20,000	20,000
MINIMUM DISTRIBUTION STRATEGY										
Prior Year-End Value ($)	250,000	254,375	257,767	259,976	260,776	259,907	257,071	251,930	244,092	233,108
Divisor	16	15	14	13	12	11	10	9	8	7
Required Distribution ($)	15,625	16,958	18,412	19,998	21,731	23,628	25,707	27,992	30,512	33,301
Earnings Rate (%)	8	8	8	8	8	8	8	8	8	8
Year-End Value ($)	254,375	257,767	259,976	260,776	259,907	257,071	251,930	244,092	233,108	218,456
SS Taxable Amount ($)	0	0	0	0	0	1,628	3,707	5,992	8,512	10,000
Taxes ($)	3,281	3,561	3,867	4,200	4,564	5,304	6,177	7,137	8,195	23,805
Total Taxable SS	$117,212									
Total Tax	$252,777									
FLAT AMOUNT PER YEAR STRATEGY										
Prior Year-End Value ($)	250,000	243,535	236,553	229,012	220,868	212,072	202,573	192,314	181,234	169,268
Divisor	16	15	14	13	12	11	10	9	8	7
Distribution Amount ($)	26,465	26,465	26,465	26,465	26,465	26,465	26,465	26,465	26,465	26,465
Earnings Rate (%)	8	8	8	8	8	8	8	8	8	8
Year-End Value ($)	243,535	236,553	229,012	220,868	212,072	202,573	192,314	181,234	169,268	156,344
SS Taxable Amount ($)	4,465	4,465	4,465	4,465	4,465	4,465	4,465	4,465	4,465	4,465
Taxes ($)	6,495	6,495	6,495	6,495	6,495	6,495	6,495	6,495	6,495	6,495
Total Taxable SS	$83,975									
Total Tax	$138,091									
EARLY YEAR LARGE DISTRIBUTION STRATEGY										
Prior Year-End Value ($)	250,000	200,000	182,000	174,560	166,525	157,847	148,475	138,352	127,421	115,614
Divisor	16	15	14	13	12	11	10	9	8	7
Distribution Amount ($)	70,000	34,000	22,000	22,000	22,000	22,000	22,000	22,000	22,000	22,000
Earnings Rate (%)	8	8	8	8	8	8	8	8	8	8
Year-End Value ($)	200,000	182,000	174,560	166,525	157,847	148,475	138,352	127,421	115,614	102,863
SS Taxable Amount ($)	17,000	10,000	0	0	0	0	0	0	0	0
Taxes ($)	39,100	24,050	4,620	4,620	4,620	4,620	4,620	4,620	4,620	4,620
Total Taxable SS	$27,075									
Total Tax	$127,861									

have your retirement investments such as IRAs more heavily weighted toward rapidly growing investments such as stocks. However, rapid growth of your IRA after retirement simply increases the amount that you need to withdraw from your IRA later, which may well increase your income taxes and perhaps expose you to the Social Security Supertax. Also bear in mind that stock value growth in an IRA may be relatively disadvantageous in today's tax environment. Such value growth in your IRA will ultimately be taxed at ordinary income tax rates. Alternatively, this same value growth in these same investments outside your IRA will be subject to a maximum capital gain tax of 20% and may be completely tax-free on your death.

If your investment objective and your financial resources permit, consider changing your investment allocations to invest in slowly growing assets inside your IRA and invest in rapidly growing stock investments outside your IRA. This will slow down the growth of your IRA and the ultimate tax and Social Security Supertax exposures on it while providing you with an overall portfolio growth consistent with your goals at a lower tax rate.

- *Consider annuitizing your distributions.* An annuitized approach would result in you withdrawing about the same amount each year (the Flat Amount Per Year Strategy in Table 1). You do not have to have an annuity investment to take advantage of an annuitization—or flat rate—distribution strategy that will help your situation. You could save a substantial amount in taxes if the flat rate can be set to keep your income below or in the lower levels of Social Security taxation while expiring your IRA over your estimated life expectancy. Such a strategy can be effective both before and at the time you reach age 70½.
- *Consider taking large distributions in your first few years.* While this strategy is particularly worthy of consideration to reduce the size of future IRA distributions in years prior to the owner's receipt of Social Security income, it can also be very useful for individuals who are "trapped" into paying escalating taxes on their IRA and Social Security benefits because they inadvisably pursued a minimum distribution strategy earlier. The Early Year Large Distribution Strategy in Table 1 demonstrates how taking a large amount out of the IRA in a couple of years after you reach age 70½ puts you back in control of your tax situation—and essentially allows you to save half of the taxes you would otherwise pay by pursuing a minimum distribution strategy for the rest of your life. While this strategy will increase your tax in the years of the larger distributions, and may even cause you to pay tax on Social Security at 85% in those years, it may be advisable to take that short-term pain to regain control of your future tax situation and save yourself substantial tax dollars in the long run.

TAILORED ANALYSIS REQUIRED

Unfortunately, generalized guidelines are difficult—each person has a particular set of financial circumstances. In addition, a complete analysis would take into consideration the time value of money, inflation, and many other factors. The purpose of this article is not to provide an answer for your particular situation, but rather to provide examples of problem situations and some ideas about how those problems might be resolved. You will need to do your own analysis to determine what course of action is best for your unique financial circumstances.

It is clear, however, that the standard "wait until you are 70½ and then take out the minimum amount" answer is not always the lowest-tax approach. ✦

80	81	82	83	84	85
20,000	20,000	20,000	20,000	20,000	20,000
18,456	199,523	175,580	145,731	108,813	63,111
6	5	4	3	2	1
36,409	39,905	43,895	48,577	54,406	63,111
8	8	8	8	8	8
99,523	175,580	145,731	108,813	63,111	0
10,843	12,067	13,463	17,000	17,000	17,000
25,188	26,840	28,725	31,602	33,642	36,689
56,344	142,387	127,313	111,033	93,451	74,462
6	5	4	3	2	1
26,465	26,465	26,465	26,465	26,465	74,462
8	8	8	8	8	8
42,387	127,313	111,033	93,451	74,462	0
4,465	4,465	4,465	4,465	4,465	17,000
6,495	6,495	6,495	6,495	6,495	40,662
02,863	89,093	74,220	58,158	40,810	22,075
6	5	4	3	2	1
22,000	22,000	22,000	22,000	22,000	22,075
8	8	8	8	8	8
89,093	74,220	58,158	40,810	22,075	0
0	0	0	0	0	75
4,620	4,620	4,620	4,620	4,620	4,651

amount. To accomplish this, consider these ideas:

- *Don't wait until 70½ to start withdrawing*. Instead, consider taking distributions immediately after you retire and before you reach age 70½. By taking money out of your IRA during your post-59½ and pre-70½ years, you can dramatically reduce the amount of IRA you will be required to take out later in life.

On the other hand, you should be careful not to withdraw too much and incur needless tax on Social Security during this period, as discussed in Example 6. If you are fortunate enough to be able to retire without needing to be eligible for Social Security right away, this window prior to Social Security eligibility can provide an excellent opportunity to take money out of an IRA without current concern about the Social Security Super-tax. Carefully controlling distributions early can keep your taxes down while keeping you in control of Social Security taxation later.

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MINIMUM DISTRIBUTION STRATEGY																
Prior Year-End Value ($)	250,000	254,375	257,767	259,976	260,776	259,907	257,071	251,930	244,092	233,108	218,456	199,523	175,580	145,731	108,813	63,111
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Earnings Rate (%)	8	8	8	8	8	8	8	8	8	8	8	8	8	8	8	8
Year-End Value ($)	254,375	257,767	259,976	260,776	259,907	257,071	251,930	244,092	233,108	218,456	199,523	175,580	145,731	108,813	63,111	0
SS Taxable Amount ($)	0	0	0	0	0	1,628	3,707	5,992	8,512	10,000	10,843	12,067	13,463	17,000	17,000	17,000
Taxes ($)	3,281	3,561	3,867	4,200	4,564	5,304	6,177	7,137	8,195	23,805	25,188	26,840	28,725	31,602	33,642	36,689
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SS Taxable Amount ($)	4,465	4,465	4,465	4,465	4,465	4,465	4,465	4,465	4,465	4,465	4,465	4,465	4,465	4,465	4,465	17,000
Taxes ($)	6,495	6,495	6,495	6,495	6,495	6,495	6,495	6,495	6,495	6,495	6,495	6,495	6,495	6,495	6,495	40,662
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Divisor	16	15	14	13	12	11	10	9	8	7	6	5	4	3	2	1
Distribution Amount ($)	70,000	34,000	22,000	22,000	22,000	22,000	22,000	22,000	22,000	22,000	22,000	22,000	22,000	22,000	22,000	22,075
Earnings Rate (%)	8	8	8	8	8	8	8	8	8	8	8	8	8	8	8	8
Year-End Value ($)	200,000	182,000	174,560	166,525	157,847	148,475	138,352	127,421	115,614	102,863	89,093	74,220	58,158	40,810	22,075	0
SS Taxable Amount ($)	17,000	10,000	0	0	0	0	0	0	0	0	0	0	0	0	0	75
Taxes ($)	39,100	24,050	4,620	4,620	4,620	4,620	4,620	4,620	4,620	4,620	4,620	4,620	4,620	4,620	4,620	4,651
Total Taxable SS	**$27,075**															
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