

Social Security and Medicare Can Raise Retirees' Tax Rates

By William Reichenstein and William Meyer

Article Highlights

- The taxation of Social Security benefits affects many lower- and middle-income households, while the income-based structure of Medicare premiums affects many higher-income households.
- Rising levels of provisional income can lead to \$0.50 or \$0.85 of each dollar of Social Security benefits being taxed, which in turn causes the effective marginal tax rate to spike.
- Since Medicare premiums increase at certain thresholds, a Roth IRA conversion could lead to higher Medicare premiums being paid two calendar years after the conversion is made.

As we mentioned in our previous article, “Retirement Planning Strategies Following the 2017 Tax Act” (March 2018 *AII Journal*), Social Security benefits and Medicare premiums can alter the effective marginal tax rate paid.

In this article, we explain in greater detail how the taxation of Social Security benefits and income-based Medicare premiums can cause a retiree’s effective marginal tax rate (the tax rate on the next dollar of income adjusted for the impact of Social Security benefits and Medicare premiums) to substantially exceed his or her tax bracket. The rules affecting the taxation of Social Security benefits affect many lower- and middle-income households, while the rules affecting the size of Medicare premiums affect many higher-income households.

The Taxation of Social Security Benefits

Here is an example to demonstrate how Social Security benefits are taxed. George is single, receives \$25,000 per year in Social Security benefits and will be at least 65 years old at the end of 2018. This would equate to a single person having a primary insurance amount (PIA) of \$2,083.33 ($\$25,000 \div 12$) who began their benefits at full retirement age (FRA). The PIA is the benefit paid at full retirement age. The taxable portion of Social Security benefits depends on his level



of provisional income (PI). For almost all taxpayers, provisional income is the sum of everything in adjusted gross income (AGI)—which includes, but is not limited to wages, dividends, capital gains and losses, traditional IRA distributions, pension income and annuity income—from their tax return except for the taxable portion of Social Security benefits plus tax-exempt interest. The sum of these numbers is provisional income.

Table 1 shows how the taxation of Social Security benefits causes a major hump—a sharp rise and then a sharp fall—in effective marginal tax rates based on the 2018 tax brackets. For most taxpayers, “Other Income” in Table 1 includes everything in AGI except the taxable portion of Social Security benefits plus tax-exempt interest. (The calculations become more complex if some of this other income consists of long-term capital gains or qualified dividends. For simplicity, we assume these amounts are zero, but the hump in the marginal tax rate curve would remain even if there are long-term capital gains or qualified dividends.)

For provisional income below \$25,000, no Social Security benefits are taxed. For most singles, the taxable level of Social Security benefits increases by \$0.50 for each dollar of provisional income between \$25,000 and \$34,000. For each dollar of provisional income above \$34,000, an additional \$0.85 of Social Security benefits is taxable. However, the maximum amount of Social Security benefits that are taxable

Table 1. Hump in Marginal Tax Rates Based on 2018 Tax Brackets

The effective marginal tax rate is the increase in taxes due for each additional dollar of other income earned within provisional income ranges. The effective marginal tax rate is the ordinary income tax bracket times the increase in taxable income. The math is ordinary income tax bracket $\times$ (1 + percentage of Social Security benefits taxed).

Other Income*	Ordinary Income Tax Bracket (%)	Increase in Taxable Income (\$)	Effective Marginal Tax Rate (%)
\$0 to \$13,233	0	1.50	0.0
\$13,233 to \$19,583	10	1.50	15.0
\$19,583 to \$21,500	12	1.50	18.0
\$21,500 to \$35,716	12	1.85	22.2
\$35,716 to \$41,206	22	1.85	40.7
\$41,206 to \$74,850	22	1.00	22.0
\$74,850 to \$149,850	24	1.00	24.0

*The other income ranges differ from the income levels shown in the 2018 ordinary income tax tables because of how Social Security benefits are taxed. See IRS Publication 915 for more information on the taxation of Social Security benefits.

is 85% of benefits received. For married couples, the same process applies, but the income thresholds are \$32,000 and \$44,000 instead of \$25,000 and \$34,000.

For George, the first \$13,233 (rounded to the nearest dollar) of other income would be taxed at 0%. His provisional income would be \$25,733 (\$13,233 + half of his \$25,000 in Social Security benefits). So, \$367 of Social Security benefits would be included in taxable income, $((\$25,733 - \$25,000) \times 0.5)$. Thus, his AGI would be \$13,600, (\$13,233 + \$367), which would be offset by his standard deduction of \$13,600, (\$12,000 + \$1,600 for being over 65). Despite the last few dollars of other income causing some of his Social Security benefits to be included in AGI, his marginal tax rate is 0%. (IRS Publication 915 has worksheets for determining your taxable Social Security benefits.)

For other income between \$13,233 and \$19,583, each dollar of income causes taxable income to rise by \$1.50 (\$1.00 of other income plus \$0.50 of taxable Social Security benefits). For this other income range, George is in

the 10% tax bracket, but 10% of \$1.50 is \$0.15, which represents a 15% effective marginal tax rate.

At other income of \$19,583, George's taxable income would be \$9,525. So, his tax bracket would rise to 12%. Each dollar of other income between \$19,583 and \$21,500 results in an additional \$0.50 of Social Security benefits to be taxed. Thus, each dollar of other income in this range causes taxable income to rise by \$1.50. Since George is in the 12% tax bracket, his effective marginal tax rate is 18% $(12\% \times 1.50)$.

At other income of \$21,500, his provisional income is \$34,000, [\$21,500 + half of Social Security benefits]. So, additional income beyond this point causes an extra \$0.85 of Social Security benefits to be taxed. Between \$21,500 and \$35,716 of other income, George's tax bracket is 12%. Each additional dollar of other income between these income levels causes George's taxable income to rise by \$1.85, so his effective marginal tax rate is 22.2% $[12\% \times 1.85]$.

At \$35,716 of other income, George's taxable income would be \$38,700. So, his tax bracket would rise to 22%. Each dollar of other income between \$35,716 and \$41,206 results in an additional \$0.85 of Social Security benefits to be taxed. Since George is in the 22% tax bracket, his effective marginal tax rate is 40.7% $(22\% \times 1.85)$.

At other income of \$41,206, 85% of George's Social Security benefits are taxed, which is the maximum allowed. Any other income above this amount does not increase the taxable portion of his Social Security benefits and thus his effective marginal tax rate is the same as his tax bracket.

Notice that the taxation of Social Security benefits causes a sharp rise and sharp fall in effective marginal tax rates. In this example, for levels of other income between \$13,233 and \$41,206, George's effective marginal tax rate is either 150% or 185% of his tax bracket. This hump in marginal tax rates is sometimes called the tax torpedo. Higher-income taxpayers usually have other income levels that are too high, especially after required minimum distributions (RMDs) begin, to avoid paying taxes on less than 85% of Social Security benefits. However, as we explain in the next section, these higher-income taxpayers should be concerned with how they withdraw funds from their savings in retirement because their withdrawal strategy can affect the future Medicare premiums they must pay.

Before leaving this section, it is important to note that if we return to the 2017 tax structure (adjusted for cost of living adjustments) as is scheduled to occur in 2026, many lower- and middle-income retirees will have much of their other income taxed at an effective marginal tax rate of 46.25%. Based on the 2017 tax structure, each dollar of other income within an income range \$34,419 to \$41,206 causes an additional \$0.85 of Social Security to be taxed. Since the taxpayer would be in the lower end of the 25% tax bracket, federal taxes alone effectively increase by \$0.4625 per each dollar of additional other income $[25\% \text{ of } \$1.85]$. Thus, if we return to the 2017 tax structure, the tax torpedo will actually become worse for many lower- and middle-income taxpayers.

A Primer on Income-Based Medicare Premiums

The Affordable Care Act (ACA) instituted higher Medicare premiums for retirees as their income level increases. In general, Medicare premiums for one calendar year are based on modified adjusted gross income (MAGI) levels from two calendar years earlier. For Medicare premiums, MAGI is defined as adjusted gross income plus tax-exempt interest. Tables 2 and 3 show how Medicare

premium levels increase as MAGI levels in 2016 breach income threshold levels.

The income threshold levels for MAGI in 2018 are \$170,000, \$214,000, \$267,000 and \$320,000 for married couples filing jointly. The respective threshold levels are 50% lower for single taxpayers. We explain how MAGI affects monthly Medicare premiums for couples, though the same logic applies to singles.

For MAGI of \$170,000 or less, the standard premium for Part B and plan premium for Part D (drugs) apply. Everyone enrolled in Medicare must take Plan B, but Plan D is optional. If the MAGI level exceeds \$170,000 by a single dollar, the monthly Part B premium increases by \$53.50 for each spouse covered by Medicare, while the Part D premium, if applicable, increases by \$13.00 per spouse per month. If both spouses are covered by Part B, but not Part D, their monthly premiums rise by \$53.50 per spouse (or \$1,284 annually for the couple). This is precisely like a \$1,284 tax increase since they must pay this additional amount to the federal government or face penalties. For jumps in Medicare premiums at MAGI thresholds of \$214,000, \$267,000 and \$320,000, their joint Part B annual increase is approximately \$1,929. The joint annual Part B and D premium increase at these income thresholds is approximately \$2,424. The annual premium increases for singles are half these amounts, but they still represent substantial increases in “taxes.”

[Due to these income-based rises in Medicare premiums, a taxpayer's marginal tax rate can far exceed 100%. For example, a married couple's final \$100 withdrawal from their 401(k) in late 2018 could push their income above the

Table 2. Medicare Premiums Levels Increase as MAGI Increases for Married Couples

This table shows how Medicare premiums increase as MAGI rises above certain thresholds for married couples filing joint returns. The standard monthly Part B premium for 2018 is \$134 per person, or \$268 for the couple. The standard Part D premium is determined by the cost of the plan chosen. The far-right column, labeled Additional Annual Premiums, denotes the additional amount a married couple taking Part B and D must pay with higher levels of income. For example, consider a married couple filing jointly taking Part B and D with a MAGI of \$214,001 in 2016. Their 2018 joint annual premium would be \$4,020 $[(\$267.80 + \$67.20) \text{ times } 12 \text{ months}]$ higher than it would have been had their MAGI been \$170,000 or less. Moreover, that last dollar of MAGI caused their 2018 annual premiums to rise by \$2,424 $[(\$267.80 - \$107.00 \text{ per month for Part B}) + (\$67.20 - \$26.00 \text{ per month for Part D}) \text{ times } 12 \text{ months}]$.

Married MAGI	Part B Premium and Surcharge	Part D Premium and Surcharge	Additional Monthly Premiums	Additional Annual Premiums
Less than \$170,000	\$268	Plan Premium (PP)	na	na
\$170,000 to \$214,000	\$268 + \$107.00	PP + \$26.00	\$133.00	\$1,596.00
\$214,000 to \$267,000	\$268 + \$267.80	PP + \$67.20	\$335.00	\$4,020.00
\$267,000 to \$320,000	\$268 + \$428.60	PP + \$108.40	\$537.00	\$6,444.00
More than \$320,000	\$268 + \$589.20	PP + \$149.60	\$738.80	\$8,865.60

Table 3. Medicare Premiums Levels Increase as MAGI Increases for Single Filers

This table shows how Medicare premiums increase as MAGI rises above certain thresholds for a single person. The standard monthly Part B premium for 2018 is \$134 per person. The standard Part D premium is determined by the cost of the plan chosen. The far-right column, labeled Additional Annual Premiums, denotes the additional amount the single person taking Part B and D must pay with higher levels of income. For example, consider a single person taking Part B and D who had a MAGI of \$107,001 in 2016. This person's 2018 annual premium would be \$2,010 higher than it would have been had their MAGI been \$85,000 or less. Moreover, that last dollar of MAGI caused the person's 2018 annual premiums to rise by \$1,212 $[(\$133.90 - \$53.50 \text{ per month for Part B}) + (\$33.60 - \$13 \text{ per month for Part D}) \text{ times } 12 \text{ months}]$.

Married MAGI	Part B Premium and Surcharge	Part D Premium and Surcharge	Additional Monthly Premiums	Additional Annual Premiums
Less than \$85,000	\$134	Plan Premium (PP)	n/a	n/a
\$85,000 to \$107,000	\$134 + \$53.50	PP + \$13.00	\$66.50	\$798.00
\$107,000 to \$133,500	\$134 + \$133.90	PP + \$33.60	\$167.50	\$2,010.00
\$133,500 to \$160,000	\$134 + \$214.30	PP + \$54.20	\$268.50	\$3,222.00
More than \$160,000	\$134 + \$294.60	PP + \$74.80	\$369.40	\$4,432.80

\$214,000 Medicare threshold. If so, their monthly Medicare premiums could rise by \$101 per person, which is equivalent to a \$2,424 rise in taxes for the couple on a full-year basis. If the couple pays \$32 in income taxes on this last \$100 withdrawal based on the 32% income tax bracket, then their effective marginal tax rate on the withdrawal would be $(\$32$

$+ \$2,424) \div \$100 = 2,456\%$ once the additional Medicare premium increase is factored in.]

The Effect of Roth IRA Conversions on Medicare Premiums

Consider John and Jan. Jan is retired

and John expects to retire within the next two years. They will both be on Medicare by 2020. John's 2018 income affects their 2020 premium levels. He can and should file Form SSA-44 with the Social Security Administration to note his specific life-changing event, which for him is his retirement and thus lower earned income. The Social Security Administration will adjust John's 2018 income to reflect his work stoppage at retirement. Other life-changing events include divorce/annulment, death of a spouse, work reduction, loss of income-producing property due to a disaster, loss of pension income and situations where income for a year was due to a settlement with an employer for the employer's bankruptcy or reorganization.

Suppose John converts \$100,000 from a traditional IRA to a Roth IRA to fully use the top of the 24% tax bracket. Since a Roth conversion is not a life-changing event, it would increase the couple's MAGI for the current year, assuming the couple files a joint return. The conversion will potentially lower their MAGI in future years by reducing the size of John's RMDs. If John were to make this Roth IRA conversion in, say, 2018, the couple should estimate

how it would affect their 2020 Medicare premiums.

Suppose John and Jan only take Part B insurance and the \$100,000 Roth conversion will cause their joint monthly premiums two years later to be \$267.80 higher than if John does not make the Roth conversion. In this example, John and Jan should consider three amounts. First, they should consider the lower taxes on the current year's Roth conversion (e.g., 24% compared to the tax rate they or their heirs would pay on the amounts held in the tax-deferred accounts that were not converted). If the couple would pay a 28% marginal tax rate on average for the \$100,000 in question in future years instead of 24% if the Roth conversion is completed in, say, 2018, then their tax savings would be \$4,000. Second, they should consider the additional Medicare premiums they would have to pay in two calendar years (e.g., 2020) from when John makes the Roth conversion (e.g., 2018). If they would jointly pay an additional \$267.80 per month, then the additional annual cost two calendar years later would be \$3,213.60. However, if they jointly had to pay an additional \$107 per month for one year, then the additional cost

would be \$1,284. Third, they should consider the lower Medicare premiums they might pay for calendar years more than two years beyond conversion date (e.g., 2021 and beyond for a Roth IRA conversion made in 2018). For instance, if John makes the Roth conversion in 2018, his required minimum distributions will be smaller in subsequent years. These smaller RMDs could cause the couple's Medicare premiums to also be lower in future years than if John does not make the Roth conversion.

Do the benefits of paying a lower marginal tax rate this year relative to future years and paying lower Medicare premiums starting three calendar years and beyond the conversion date exceed the additional Medicare premiums owed two calendar years beyond the conversion date?

Possibly. The actual answer requires running a scenario analysis with several assumptions being made, including future income, tax rates and Medicare premiums. Such analyses could be done with a spreadsheet, though many may find it easier work with an adviser or to use software such as we offer on our company's website at www.socialsecuritysolutions.com. ▲

William Reichenstein, CFA, holds the Pat and Thomas R. Powers Chair in Investment Management at Baylor University and is head of research at Social Security Solutions Inc. William Meyer is founder and CEO of Social Security Solutions Inc., a service that provides personalized recommendations as to when to claim Social Security benefits. Find out more about the authors at www.aaii.com/authors/william-reichenstein and www.aaii.com/authors/william-meyer.