Social Security Highlights

An In-Depth Case Study on Social Security Taxation

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When you take a serious look at the nuts and bolts of Social Security taxation, the results are staggering. And so is the amount of money you can save if you plan properly.

And by planning properly, we mean that you can save a great deal of money in taxes simply by using the cash value in a life insurance policy to provide retirement income, rather than using, for example, a distribution that is taxable, such as a traditional IRA. This article shows you how.

But before we get to that, we need to take a quick look at how the income taxation of Social Security works. The calculation is far more complicated than you might expect. For example, tax-free income from municipal bonds is counted in the formula for taxing Social Security benefits, even though this income doesn't generate an income tax directly. So in some situations, tax-free income could result in a higher tax bill because more of your Social Security is taxable.

Basically, anywhere from 0 percent to 85 percent of your Social Security income can be taxable. It all depends on your other income. Generally, a married couple relying just on Social Security for their retirement income is likely to see 0 percent of their Social Security taxed. A married couple with a significant amount of other income, be it from employment, dividends or other taxable investments, is likely to see 85 percent of their Social Security taxed.

Look at the following examples in Table 1. There are three different scenarios. In each, a married couple receives $40,000 this year in Social Security income. And their total income in each case is $90,000. So we have married taxpayers all receiving the same amount of money. But the source of that income is what's different.

In Scenario 1, the couple receives a distribution of $50,000 from an IRA, plus the $40,000 from Social Security. This IRA income, if it is not from a Roth IRA, is taxable.

In Scenario 2, they receive $40,000 from an IRA, and the rest ($10,000) as a non-taxable loan from a life insurance policy.

And in Scenario 3, they receive 30,000 from an IRA and the rest ($20,000) as a non-taxable loan from a life insurance policy.

So in Scenario 1, the maximum amount of the Social Security income is taxable (85 percent).

TABLE 1
Tax Year 2019
Married Couple Filing Jointly – Both Age 65+, Standard Deductions; $90,000 Gross Income

	Scenario 1	Scenario 2	Scenario 3
Calculation			
Social Security Income	$40,000	$40,000	$40,000
Taxable SS Income	28,100	19,600	5,100
IRA Distribution	50,000	40,000	30,000
Adjusted Gross Income	78,100	59,600	35,100
Standard Deduction	(27,000)	(27,000)	(27,000)
Taxable Income	51,100	32,600	8,100
Tax	7,044	3,524	810
Loan from Insurance Policy	0	10,000	20,000
Analysis			
Gross Income	$90,000	$90,000	$90,000
Net Income	82,956	86,476	89,190
Tax Savings		**3,520**	**6,234**
15 Year Present Value @ 5%		**$36,536**	**$64,707**

Income tax due based upon 2019 Federal income tax tables. Source: Kenneth Sokol

In Scenario 2, something less than that is taxable (28.5 percent). In Scenario 3, 10 percent of it is. Keep in mind that the couple is still receiving the same amount of gross income: $90,000. It's just a different form of income. But the tax savings in Scenario 3 vs. Scenario 1 are just over $6,200. And that's just for one year!

There is an important caveat here, though. You need to remember that generally you get a tax deduction when you contribute to an IRA. This is not true for a life insurance policy. Thus, an IRA often results in a lower tax bill while it's being funded, but may provide for a higher tax bill in retirement.

One quick note about something the news media like to refer to as the "tax torpedo." This term simply means that income taxes on your Social Security income may be worse than you realize. Taxable distributions—for example, from an IRA—often have the unintended effect that more of your Social Security income will be taxable.

This is a perfect example of the tax torpedo and how to reverse it. The bottom line here is that by using life insurance, you end up saving money because properly designed withdrawals and loans from a life insurance policy can be tax-advantaged under current law. You save even more because using the life insurance means that less of your Social Security income is taxable.

Your Security Mutual agent can help you evaluate your options. Our software, the Security Mutual Life Social Security Evaluator, can provide an easy-to-understand illustration that breaks down how much of your Social Security is taxable. For a sample, see Table 2, which is based upon a real life example.

TABLE 2
Sample Tax Threshold Output
from Security Mutual Life's Social Security Evaluator

Both spouses file at full retirement age.

Prepared for: John & Mary

Year	Ages	Social Security Income	50% Threshold Reached	50% Maximum	85% Threshold Reached	Maximum SS income Taxable
2019	67 / 67	$40,008	$12,000	$24,000	$24,000	$64,000
2020	68 / 68	$40,008	$12,000	$24,000	$24,000	$64,000
2021	69 / 69	$40,008	$12,000	$24,000	$24,000	$64,000
2022	70 / 70	$40,008	$12,000	$24,000	$24,000	$64,000
2023	71 / 71	$40,008	$12,000	$24,000	$24,000	$64,000
2024	72 / 72	$40,008	$12,000	$24,000	$24,000	$64,000
2025	73 / 73	$40,008	$12,000	$24,000	$24,000	$64,000
2026	74 / 74	$40,008	$12,000	$24,000	$24,000	$64,000
2027	75 / 75	$40,008	$12,000	$24,000	$24,000	$64,000
2028	76 / 76	$40,008	$12,000	$24,000	$24,000	$64,000
2029	77 / 77	$40,008	$12,000	$24,000	$24,000	$64,000
2030	78 / 78	$40,008	$12,000	$24,000	$24,000	$64,000
2031	79 / 79	$40,008	$12,000	$24,000	$24,000	$64,000
2032	80 / 80	$40,008	$12,000	$24,000	$24,000	$64,000
2033	81 / 81	$40,008	$12,000	$24,000	$24,000	$64,000
2034	82 / 82	$40,008	$12,000	$24,000	$24,000	$64,000
2035	83 / 83	$40,008	$12,000	$24,000	$24,000	$64,000
2036	84 / 84	$40,008	$12,000	$24,000	$24,000	$64,000
2037	85 / 85	$40,008	$12,000	$24,000	$24,000	$64,000
2038	86 / 86	$40,008	$12,000	$24,000	$24,000	$64,000
2039	87 / 87	$40,008	$12,000	$24,000	$24,000	$64,000
2040	88 / 88	$40,008	$12,000	$24,000	$24,000	$64,000
2041	89 / 89	$40,008	$12,000	$24,000	$24,000	$64,000
2042	90 / 90	$40,008	$12,000	$24,000	$24,000	$64,000

In some years the 85% threshold may be reached before 50% of Social Security becomes taxable.

Combined income as defined by Social Security includes your adjusted gross income, tax-exempt interest income and half of your Social Security benefits. However, a more precise definition can be found in IRS Pub. 915, pg. 6. (https://www.irs.gov/pub/irs-pdf/p915.pdf)

Social Security tax thresholds for a single person are $25,000 for 50% and $34,000 for 85%.

Social Security tax thresholds for a couple, Married Filing Joint (MJF), are $32,000 for 50% and $44,000 for 85%.

The reference table used to generate this information provides details based upon $1,000 increments of Social Security income. Therefore, the projected Social Security income is rounded down to the closest $1,000 increment.

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