# Social Security Taxation and Roth Conversion

**April 19, 2016**

**by John Walton, PhD, PE**

*Advisor Perspectives welcomes guest contributions. The views presented here do not necessarily represent those of Advisor Perspectives.*

The actuarial adjustments that the Social Security (SS) administration uses to calculate benefits beyond full retirement age have not been updated since 1983. In the intervening years lifetimes have increased and real interest rates have decreased. Longer lives and lower interest rates mean that delaying SS benefits until age 70 is increasingly recommended by financial advisers to increase financial security in retirement.

For most clients who have worked more than 35 years, which is the maximum considered in calculating benefits, delaying SS provides substantial increases in benefits, whereas working more years often does not. Additional years of SS-eligible income beyond 35 years only increase benefits to the extent that the wages earned in subsequent years exceed wage-adjusted income from prior years.

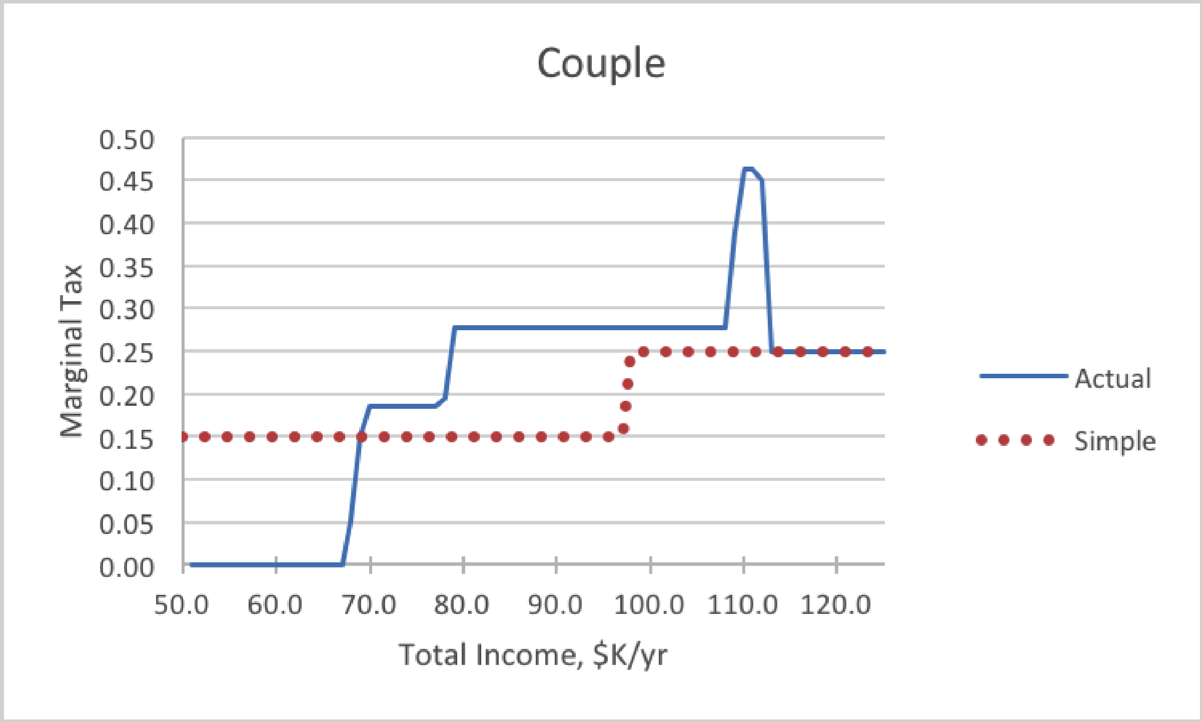
Setting up a bond ladder to provide secure income in lieu of SS from the age of retirement until age 70 is the easiest way to fund delaying SS. This requires that assets be spent down at a relatively higher rate prior to receiving the enhanced SS payout (i.e., “buying more Social Security”).

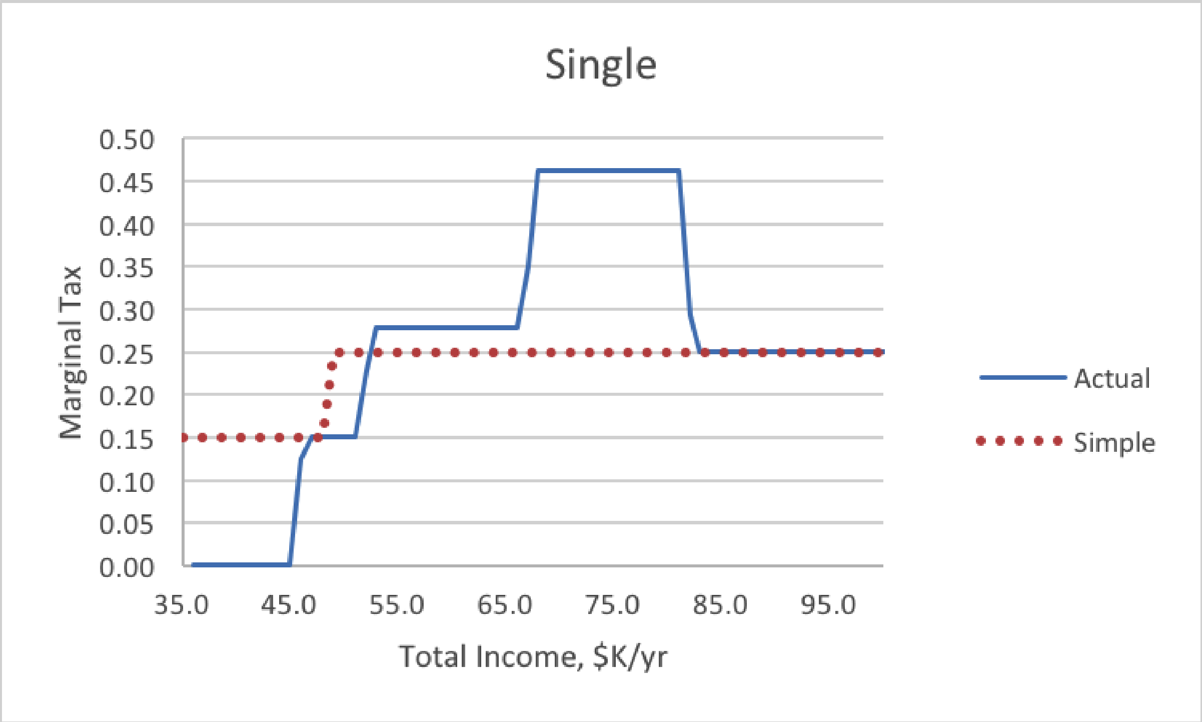
Given the increased SS benefit from delay and the required extra spend down of assets to “purchase the enhanced SS benefit,” SS will be a greater portion of total income. SS will also be a large portion of income for the many Americans who do not have adequate savings.

Prior to age 70.5, when required minimum distributions (RMDs) begin, clients should consider converting all or a portion of their 401K/403B/IRA savings into a Roth IRA. Conversion to a Roth IRA depends primarily on tax rates at the time of rollover relative to rates in the future.

The unique way that SS benefits are taxed dramatically changes the marginal tax on retirement income, particularly for clients with benefits enhanced by delay until age 70. At low levels of total income, SS benefits are tax free, but as income increases, up to 85% of benefits are taxable. Since an additional dollar of outside income can make more SS income taxable, the extra dollar of income requires the payment of tax on the extra dollar, plus tax on the newly taxable portion of SS. At some points in the formula, this turns the 15% tax bracket into (1 + 0.85)*.15 = 27.75% and the 25% tax bracket into 46.25%. This makes conversion to Roth substantially more beneficial, even if the client appears to be in a higher tax bracket today relative to retirement.

Consider two examples: First, a married couple with a combined $50,000/year in SS benefits, and second, a single person with $30,000 /year in SS benefits. The total income in the figures below includes the SS benefit plus taxable income from an IRA or pension. The simple dots are the normal marginal tax brackets for ordinary income. The “actual” line shows the marginal tax that would be paid in both examples given the rules for taxation of the SS and the IRA/pension income.




For the couple, the marginal tax bracket including the effects of Social Security taxation exceeds 25% for retirement income from approximately $70-112K/year. This means that conversion to Roth in this retirement income range would be beneficial even if income at the time of conversion put the couple in the 25% tax bracket. Notice that the simplistic tax bracket puts them into either the 15% or 25% bracket for the same income range. At income greater than about $112K/year the effect of SS taxation goes away, and they move back to the 25% bracket. In this range, the peak in marginal taxation *does not* occur at the last dollar of income as is generally anticipated. Roth conversion could be used to eliminate the spike up to 46%, a substantial tax savings.

For the single individual in the example the effect is even more dramatic as a large range of income will be taxed at 46% prior to moving back down to 25% at higher incomes. If potentially taxable income can be taken below this 46% spike through Roth conversion prior to age 70.5, the client would obtain significant tax savings (adviser alpha!).

The anomalous tax behavior flips for the situation where SS is almost all of the income. For both the couple and the single individual in the examples, if the IRA income is less than about $15K/year, Roth conversion would not be recommended.

The income levels used to calculate taxation of Social Security are not indexed for inflation, whereas SS benefits are inflation adjusted. Thus, the spikes in taxation will move over time with inflation.

*John Walton is an Engineering Professor at the University of Texas at El Paso, where he has taught for 24 years. He has a PhD in Chemical Engineering. His interest in financial planning came from considering options for his coming retirement.*