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Taxation of Social Security Benefits

Taxes are what we pay for a civilized society — Oliver Wendell Holmes Jr. (U.S. Supreme Court Justice from 1902-1932)

In the February issue of IPE Insights, I spoke about two ways that our Social Security benefits could be reduced – 1) by earning too much income before Full Retirement Age (FRA) thus incurring a penalty on our benefit and 2) by paying federal income tax on our benefits. After a short review of excess earnings before FRA, the primary focus of today's article will be on federal income taxation of Social Security benefits.

If you claim benefits earlier than your Full Retirement Age and have wages and salary greater than $15,120 in 2013, then $1 of benefits is withheld for every $2 that you earn above $15,120. Both wages earned as an employee (W-2) and net earnings from self-employment (1099) are combined to determine an individual's total earnings for the year. There are some types of income that do not count in the calculation: interest and dividends from stocks and bonds, worker' compensation and unemployment compensation, distributions from Individual Retirement Accounts (IRAs), pensions and retirement pay etc. The Senior Citizens' Freedom to Work Act of 2000 eliminates the $15,120 earnings cap and penalty for people who have attained Full Retirement Age.

In addition to the earnings limitation for those under FRA, a portion of Social Security payments for all recipients may be subject to federal income tax if certain income thresholds are exceeded. As much as 85% of your Social Security benefits may be subject to federal income tax. Taxation of these benefits will be discussed in the rest of this article.

If Social Security is your only source of income, the benefits generally are not taxable and you probably do not need to file an income tax return. However, if you have other income, like many people do, such as a pension, investment income, annuities, rental income, W-2 wages, 1099 income, etc., then up to 85% of your Social Security benefit may be taxable. It should be noted that tax-exempt interest is included for this Social Security calculation even though it is not included as taxable income on your 1040 tax return. However, interest from United States savings bonds is excluded as well as income earned in a foreign country, United States possessions or Puerto Rico. You can determine if your Social Security benefits will be taxable by going through the following steps:

First, add up all of your income sources other than Social Security. For most people, this is the sum of wages, taxable interest, realized capital gains and other income. If the total of a person's income plus half of his or her Social Security benefits is more than the amounts listed below, then some of the benefits are taxable. The following categories represent current brackets for determining taxation of Social Security benefits:

$32,000 for married couples filing jointly

$25,000 for single, heads of household, or qualifying widow/widower with a dependent child

$0 for married individuals filing separately who lived together at any time during the tax year

$25,000 for married individuals filing separately and who did not live with their spouses at any time during the tax year

Stated as a formula, Income + tax-exempt interest + 50% of Social Security benefits greater than your bracket amount listed above ($32,000, $25,000, $0 or $25,000) will result in taxation of some of your Social Security benefits.

How much of someone's benefits are subject to income tax? That depends upon how much your income exceeds the bracket amounts listed above. Smaller overages may lead up to 50% of the benefit being taxable. Larger overages may lead up to 85% of the benefit being taxable. The calculation of "how much" is best left to software programs or a tax professional (I do have one of those software programs at my office). If you think that this explanation of Social Security taxation sounds complex, it is. Tax rules are rarely simple. In light of the Justice Holmes quote above, we can't ever seem to escape the tax man, can we?

The guest article on Target Date Funds is from the Financial Planning Association. Many work related retirement plans are now offering these type funds as an investment choice. Investors often think that these fund choices are without risk and cannot lose money. That is not the case as the down market of 2008 proved. These funds follow an investment path based upon years to retirement; they do not adapt to current market conditions which may be unfavorable to the target path at any given time. As an alternative, I do offer customized Money Management for the retirement accounts (401K, 403B etc.) of clients who are still working. I would be happy to discuss this service with you. As we approach this Memorial Day holiday, let us pay tribute to the men and women who made the ultimate sacrifice for the freedom we have in this country. Take good care!!!

Target-Date Funds: Are they Right for you?

Target-date funds provide investors with the ability to simplify their financial and investment lives.[1] With target-date funds, your portfolio's asset allocation is automatically rebalanced on your behalf over the years by professional investment managers, generally growing more conservative as the identified target date approaches.

Unlike lifestyle funds, target-date funds do not require investors to reassess their priorities and transfer money to a different fund as goals approach and priorities change. Generally speaking, the name of each target-date fund includes a specific year, such as "2030" or "2045." All you need to do is choose a fund named for the year closest to the year of your projected retirement. From that point on, professional investment managers make all the investment decisions.

Understanding the Investment Strategy

Target-date investments follow what is known as a "glide path." The glide path maps out the investment's asset allocation over time -- the way it is divided between the principal asset classes of stocks, bonds, and cash. How your assets are allocated among these investments is a major factor in determining portfolio volatility and risk.[2] As you approach retirement, a target-date investment typically reduces its holdings of stocks, while increasing its exposure to less risky bonds and cash. Target-date investments provide investors with instant diversification into different asset classes.[2]

A target-date investment's goal is to make the investing process simple. This "set it and forget it" style also makes investors less likely to allow short-term market fluctuations to adversely affect their investment decisions.

A "New Generation" of Target-Date Investments

The principal value of many target-date investments cannot be guaranteed at any time, including the target date, and may decline at any time. However, there are newer models that offer a way to protect all or some of your portfolio from market declines. These newer options are often tied to a feature that offers a lifetime income guarantee upon retirement.

Target-date options may be ideal investments for those participants who have a long time horizon and for those who don't feel comfortable investing on their own. Be sure to review the glide paths of the target-date investments offered through your plan. If you have any questions, ask your plan administrator or financial professional.

Source/Disclaimer:

[1]The principal value of target-date funds is not guaranteed at any time, and you may experience losses, including losses near, at, or after the target date, which is the approximate date when investors reach age 65. The funds emphasize potential capital appreciation during the early phases of retirement asset accumulation, balance the need for appreciation with the need for income as retirement approaches, and focus more on income and principal stability during retirement. There is no guarantee that the funds will provide adequate income at and through your retirement.

Target-date funds invest in a broad range of underlying mutual funds that include stocks and bonds and are subject to the risks of different areas of the market. Target-date funds maintain a substantial allocation to stocks both prior to and after the target date, which can result in greater volatility. The more a target-date fund allocates to stock funds, the greater the expected risk. For further details on the risks associated with investment in a target-date fund, please refer to the fund's prospectus.

[2]Asset allocation and diversification do not ensure a profit or protect against a loss.

[3]Source: S&P Capital IQ Financial Communications. Example is hypothetical and does not represent any specific target-date investment.

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