Social Security Benefits: How Much Is Subject to Taxes?

Social Security retirement benefits provide a cadence of guaranteed income. But do clients know exactly how much of their Social Security benefit is taxed?

The taxation of Social Security retirement benefits can be a source of great confusion for both taxpayers and even those within the financial services industry. Many mistakenly assume benefits are either entirely tax free or subject to an 85% tax rate. While some may not pay taxes on their benefits, those who do often are surprised to find the taxable portion is smaller than anticipated.

These insights can help clients understand how their Social Security retirement benefits may be taxed, which also can clarify when and how they should claim.

At least 15% of Social Security are free from Federal Income Taxes

Social Security retirement benefit payments may be subject to federal income taxes, and the chart below outlines the taxation thresholds. If a client's provisional income exceeds a threshold, then, up to that portion of their benefit is included in the client's adjusted gross income (AGI). The maximum inclusion is 85%, leaving 15% free of federal income taxes.

It's also important to note that these numbers are the maximum amounts that can be included in taxable income. The actual number could be less based on the three-part test, which we'll cover below.

100% tax-free	Up to 50% taxable	Up to 85% taxable
• ≤ $25,000 Individual • ≤ $32,000 Joint	• $25,001–$34,000 Individual • $32,001–$44,000 Joint	• ≥$34,001 Individual • ≥ $44,001 Joint

Source: Social Security Administration. "Publication 05-10035, Retirement Benefits." January 2024. Accessed March 18, 2024.

The Three-Part Test Can Further Adjust Taxation

The three-part test uses additional client information to calculate his or her actual amount of taxable Social Security retirement benefits. As shown in the tables included here, the test calculates taxable income three ways: 85% of the total Social Security benefit, 50% of the total benefit plus 85% of a married couple's combined income (CI) over the second threshold listed in the example to the left, or 50% of CI over the first threshold plus 35% of CI over the second threshold. Whichever value is lowest is the actual amount of a client's Social Security retirement benefit subject to federal income tax.

To outline how this works in practice, imagine a married couple with a combined annual Social Security retirement benefit of $51,000 and $45,000 in additional income subject to federal income tax.

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Here's how the three-part test would be used to calculate this couple's federally taxable income:

Test for taxation: Lowest of these three tests is the amount subject to taxation

Test #2	Test #2			Test #3		
85% of Social Security Benefits	**50%** of Social Security Benefits	+	**85%** of CI over the 2nd threshold	**50%** of CI over the 1st threshold	+	**35%** of CI over the 2nd threshold
Based on the provisional income chart, an 85% inclusion would translate to $43,350 subject to income taxes. With the couple's additional income, the math works out to: ½ ($51,000) + $45,000 = $70,500	50% of combined Social Security retirement benefits + 85% of CI over second threshold: ½ ($51,000) + .85 ($26,500) = $48,025			50% of CI over first threshold + 35% of CI over second threshold: ½ ($38,500) + .35 ($26,500) = $28,525		

Test 3 provides lowest inclusion amount at $28,525—or 56%.

This is a complicated transaction and illustrates why Social Security retirement benefits can be subject to more favorable tax treatment than other forms of retirement income. By fully understanding the three-part test, you can help clients make claiming decisions that align best with their personal tax situations.

You Can Help Clients Develop an Intuitive Claiming Strategy

The decision to claim Social Security retirement benefits has multiple planning implications, and taxes will play a significant part. With partially tax-exempt income at the federal level, individuals may find that their MAGI is lower than anticipated, allowing them to take advantage of tax-planning opportunities that might be available with lower MAGI. An example is a Roth conversion. The conversion adds to ordinary income but could be an amount that does not exceed the current tax bracket. Taxpayers can manage their retirement-income tax obligations which may allow them to keep more of their income to maintain their desired retirement lifestyles. Remember that in retirement, taxes are paid by the retiree's income, including distributions from savings and qualified accounts. If the retiree is required to take a larger distribution from his or her accounts to cover taxes, it can affect how long the portfolio assets will last. The sustainability of the portfolio potentially affects retirement lifestyle.

ACTIONS YOU CAN TAKE RIGHT NOW

- **Identify clients who plan to retire within three to five years.**
- **Evaluate how potential tax burdens might affect Social Security claiming decisions.**
- **Meet with each client to determine and manage taxes in their retirement-income strategy.**

Additional Resources and Links

[How Much of My Social Security Benefit May Be Taxed?]
[Social Security Analyzer]
[Social Security and Longevity Planning—It's a Match]

For more information about retirement planning, please contact our Retirement Strategies Group at RSG@PacificLife.com or (800) 722-2333, ext. 3939.

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