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Trust UPDATE

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Beware the Social Security “Tax Torpedo”

In some situations, retirees face marginal tax rates approaching 50%!

Social Security benefits have potentially been subject to federal income tax since 1983. “Potentially taxable” means that lower income retirees won’t have to pay these taxes; there is an exemption. However, the thresholds for taxation were not indexed to inflation and have never been adjusted. That means that more and more retirees will be faced with this tax puzzle. The “tax torpedo” is the amount of additional tax liability generated by an additional dollar of retirement income.

The starting point is Adjusted Gross Income (AGI), a number familiar to everyone who has ever filed a Form 1040. AGI includes wages, interest income, dividends, capital gains, pensions, and retirement plan distributions. To this figure one adds in nontaxable interest income, such as that from municipal bonds, and one-half of the Social Security benefits received. The result is “provisional income.”

Those with provisional income of less than $25,000 ($32,000 for married filing jointly) pay no taxes on Social Security benefits. For provisional income from $25,000 to $34,000 ($32,000 to $44,000 for married filing jointly), up to 50% of benefits are taxable. Above $34,000 ($44,000 for married filing jointly), up to 85% of benefits become taxable. Table one below provides the summary.

An additional dollar of taxable retirement income thus has the potential of pushing more of a retiree’s Social Security benefit into the taxable zone. Imagine a retiree needs to withdraw $1,000 from an IRA to pay bills. The withdrawal needs to be large enough to cover the income tax on the withdrawal, plus the additional tax on benefits.

The capital gains “bump zone”

Now add this wrinkle. In the bottom tax bracket, the tax rate on long-term capital gains is 0%. However, as income

Table One

Social Security Benefit Tax Thresholds

	PROVISIONAL INCOME BY FILING STATUS	
Percentage of benefits taxed	Married filing jointly	Single filer
No tax	Below $32,000	Below $25,000
Up to 50%	$32,000 to $44,000	$25,000 to $34,000
Up to 85%	Above $44,000	Above $34,000

Source: Social Security Administration; M.A. Co.

Our services for retirees

You don't have to be retired to benefit from these financial services, but if you have started your retirement (or plan to soon), you should give them some careful consideration. At your request, we'd be happy to tell you more.

• **IRA rollovers.** When you receive a plan payout, you may preserve tax advantages for your retirement capital by arranging for an IRA rollover. Do you already have such an account with another firm, but feel lost in the shuffle? We'd be happy to help you move your IRA so that you can begin to benefit from our personalized investment management.

• **Personal investment accounts.** After careful study of your goals and circumstances, resources and risk tolerances, we recommend, implement and monitor a personalized investment program for you. Because we charge annual fees linked to market value, our best interests and the best interests of our clients are clearly linked.

• **Living trusts.** The same personalized investment guidance is available to clients who wish to set up their investment programs as revocable living trusts. A trust-based financial plan doesn't impair the client's control of his or her investments, but it does offer such added benefits as probate avoidance, integration with the estate plan and financial management in the event of prolonged illness or incapacity.

goes higher, there is the possibility of the capital gains being pushed into taxable territory.

Writing in *The New York Times*, Peter Coy offered this example for a single taxpayer. A single taxpayer in the 12% tax bracket has at least $2,000 of long-term capital gains and needs to take a $1,000 withdrawal from his IRA. Tax consequences? The tax on the IRA withdrawal is $120. The withdrawal may push $1,000 of the capital gain into the 15% bracket, for a tax of $150. The increase in provisional income exposes an additional $850 worth of Social Security benefits to the 12% income tax, for $102. Finally, the addition of the Social Security benefits to taxable income pushes still more of the capital gain into the 15% bracket, triggering a tax of $127.50.

The total tax cost of the $1,000 withdrawal is $499.50, very nearly a 50% tax rate. That's the "tax torpedo" in action.

At higher income levels

Once 85% of Social Security benefits are fully included in a retiree's taxable income, there is no longer a need to factor in this tax angle when making discretionary retirement withdrawals or investment decisions. However, a new tax torpedo then shows up on the radar.

Medicare Part B monthly premiums are not flat, they go higher as modified adjusted gross income goes up, ranging from $174.70 at the low end to a maximum of $594.00. One dollar of additional income over the threshold can mean hundreds of dollars in higher premiums. The premiums are based on modified adjusted gross income from two years earlier, and are adjusted annually. The table below shows the breakpoints for 2024.

Planning ahead

One approach for reducing exposure to the tax torpedoes is to convert retirement resources to a Roth IRA for greater flexibility. Such conversions create ordinary income in the year that they occur, and so should be spread out over a number of years, if possible, to smooth the tax impact. The conversions should be completed before starting to receive Social Security benefits to avoid triggering more taxes on them. Keep in mind also that a conversion two years before joining Medicare will likely boost the Part B premiums for at least a year.

Required Minimum Distributions from retirement accounts must begin at age 73, and these have the potential to push more benefits into the taxable zone. (Roth IRAs do not have required distributions during the life of the owner.) For the philanthropically minded, a Qualified Charitable Distribution (QCD) will avoid adding to adjusted gross income (limit of $100,000 per year). A QCD satisfies the minimum distribution requirement.

Put us on your team

You may want to consider professional help in preparing and implementing your retirement plans. We specialize in two areas of personal financial management:

- Helping clients to *achieve* financial independence, using tax-sensitive techniques as appropriate.
- Helping clients to *maintain* financial independence by providing unbiased investment advice and trusteeship.

For specifics on how we might help you, see our asset-management specialists. ☐

Table Two

Medicare Part B MAGI Thresholds for 2024 (based upon 2022 income)

Single taxpayers 2022 MAGI	Married filing jointly 2022 MAGI	Monthly premiums
$0 - $103,000	$0 - 206,000	$174.70
$103,000 - $129,000	$206,000 - $258,000	$244.60
$129,000 - $161,000	$258,000 - $322,000	$349.40
$161,000 - $193,000	$322,000 - $386,000	$454.20
$193,000 - $500,000	$386,000 - $750,000	$559.00
Over $500,000	Over $750,000	$594.00

Source: Centers for Medicare & Medicaid Services, CMS.gov; M.A. Co.

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The most popular names for babies

The Social Security Administration manages an extensive website at ssa.gov, full of useful information for retirees and pre-retirees. In the course of collecting applications for new Social Security numbers as babies are born, the agency has also compiled a record of baby names. At https://www.ssa.gov/oact/babynames/index.html you will find the home page for this data, and it is quite interesting. The most popular names may be displayed:

- by state;
- by decade;
- by change in popularity from 2022 to 2023;
- as the top 100 names in the last 100 years; or
- as the top 5 names for boys and girls for each year in the last 100 years.

Below are top ten extracts from the tables for the most popular names in the 2010s, and the most popular names in the last 100 years. There isn't much overlap. Only three boys' names – James, Michael and William – are on both lists, and no girls' names are on both.

The most popular name for a baby boy in 2023 was Liam. That name entered the top five in 2014 and has held the number-one spot since 2017. The most popular name for a baby girl, Olivia, entered the top five in 2003, and it has been number one since 2019.

The most popular boy's name, James, has been ranked as low as 16th, and the most popular girl's name, Mary, has been ranked as low as 135th.

Table One:

Popular Baby Names from the 2010s

	Males		Females	
Rank	**Name**	**Number**	**Name**	**Number**
1	Noah	183,258	Emma	194,988
2	Liam	173,939	Olivia	184,487
3	Jacob	163,197	Sophia	181,091
4	William	159,893	Isabella	170,491
5	Mason	157,833	Ava	155,802
6	Ethan	149,051	Mia	129,044
7	Michael	145,106	Abigail	118,690
8	Alexander	142,102	Emily	117,599
9	James	139,624	Charlotte	102,449
10	Elijah	137,025	Madison	98,393

Table Two:

Popular Baby Names from 1924 to 2023

	Males		Females	
Rank	**Name**	**Number**	**Name**	**Number**
1	James	4,586,625	Mary	2,985,148
2	Michael	4,350,425	Patricia	1,546,373
3	Robert	4,305,346	Jennifer	1,470,260
4	John	4,304,850	Linda	1,448,217
5	David	3,563,511	Elizabeth	1,395,049
6	William	3,443,460	Barbara	1,379,146
7	Richard	2,406,731	Susan	1,101,447
8	Joseph	2,281,833	Jessica	1,048,185
9	Thomas	2,125,282	Karen	986,083
10	Christopher	2,054,571	Sarah	985,596

Source: https://www.ssa.gov/oact/babynames/index.html

Termination of a Marital Trust during life

Sally and Alvin created the Anenberg Family Trust in 1987 to manage their family business. When Alvin died in 2008, the Family Trust divided into new trusts, including a QTIP Marital Trust for Sally and trusts for Alvin's descendants.

In 2011, the trustee for Sally's trusts filed a petition to terminate the Marital Trust, which was granted in 2012. In August 2012, Sally made two gifts of stock worth $1.6 million each to two trusts, and in September 2012 she sold the balance of her holdings, worth about $22 million, to the trusts for Alvin's descendants in exchange for promissory notes. The gift tax return reported the $3.2 million transfers.

After Sally died in 2016, the IRS concluded that she owed a $9 million gift tax on the termination of the QTIP trust.

The estate took the matter to the Tax Court, which ruled that "The Commissioner would have us treat the circumstances here the same from a gift tax perspective as we would treat a termination of the Marital Trusts that was followed by a hypothetical distribution to Sally of the value of her qualifying income interest only, with the value of the remainder interests distributed to Steven and Neil. But the two situations are not remotely the same." No gift tax was due on this Marital Trust termination.

The smell test

A Virginia couple purchased 85 acres in Georgia for $1.35 million. They subdivided the property into two parcels, 44 and 41 acres. Next, they donated a conservation easement over the 41-acre parcel to Liberty County, Georgia.

On their 2007 partnership tax return, the couple claimed a charitable deduction of $5.1 million for the conservation easement donation. Only $748,702 could be claimed in that tax year; the rest was carried forward.

The IRS audited the couple in 2015 and disallowed the carryforwards for tax years 2010 and later (the statute of limitations had expired for earlier years). They took the matter to the Tax Court and lost.

The couple appealed to the Fourth Circuit Court of Appeals with no better luck. The Court identified a variety of errors in their legal arguments. "But more remarkable was their attempt to claim a $5.1 million deduction for a limited easement estate on property that they had purchased in fee simple for $652,000 only a year earlier. Such a claim simply does not pass any reasonable smell test, much less the tax law's requirements."

The Court sustained a 40% gross valuation misstatement penalty. ☐

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