The Real Tax Effect of IRA Distributions

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Introduction

The purpose of this paper is to compare and analyze the "real" tax effect of Traditional IRA distributions. This paper demonstrates that an often overlooked but extremely important consideration is the impact that income from an IRA will have on the taxation of Social Security (SS) benefits. The paper begins with a cursory review of the current rules for distributions and taxation of traditional IRAs to the account owner. There are several variables that affect the taxation of an IRA distribution, and the variables are reviewed using different scenarios to identify potential misconceptions and to identify planning opportunities that may be available. The paper concludes with a discussion of how the results may be applied by practitioners in financial planning and estate planning.

Previous Research

Particular attention has been paid to the difference between IRA options, required minimum distribution requirements, and taxes. Comparisons of the traditional IRA and Roth IRA are provided by Kutner, Doney, and Trebby (2001), Anderson and Murphy (1998), Burman, Gale, and Weiner (2001), and Bahr (2000). Sigler (2002), Blatt (2001), Cline (2001), and Kistner (2001) discuss how the value of a retirement portfolio is affected when applying required minimum distributions from employer-sponsored retirement plans, 403(b) plans, and individual retirement accounts. Wedin (2000) discusses how taxes can be minimized when planning IRA distributions.

Traditional IRAs

Traditional IRAs were introduced in 1974 to encourage individuals to invest assets for withdrawal during retirement. The Traditional IRA may allow an income tax deduction for the contribution made into the IRA. The investments inside the IRA and any earnings thereon grow tax deferred, which allows the value to grow at a higher rate than an equivalent investment that may be taxed on an annual basis. However, when distributions are made from a traditional IRA, all distributions are treated as ordinary income subject to income tax on the beneficiary's personal tax return. In addition, an important consideration which is rarely considered is the distribution effect on the taxation of SS benefits. Traditional IRA owners must begin taking minimum required distributions (MRDs) when they turn 70½.

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The Uniform Lifetime Table (IRS, Publication 590, Appendix C, Table III), can be used to determine an account owners required distribution[1]. At age 70 the required distribution is based on a 25.6 year distribution period; therefore, an account owner with $100,000 in an IRA would take a MRD of $3906 ($100,000/25.6) or approximately 3.9% of the IRA balance. An account owner age 90 uses an 11.4 year distribution period and would thus need to take approximately 8.8% (1/11.4) of the IRA balance as a MRD, and the percentage continues to increase until age 115 or older at which time the distribution period remains 1.9 years. Thus, it is very possible than an IRA balance will continue to grow when the account owner is younger and the MRD percentage is lower, if the investment return on the IRA is greater than the MRD. Roth IRAs are not affected by the above table as Roth IRAs have no minimum required distributions.

An IRA owner may take distributions that are greater than the MRDs; however, this reduces the amount of tax deferral and thus the tax benefits of an IRA. The analysis in this paper also applies to the distributions from qualified retirement plans such as a 401k or 403b. Given the importance and role that IRAs will play for many individuals in their retirement wealth, this research raises important, relevant issues for individuals to consider in choosing IRAs.

Purpose of Research

Financial planning recommendations are often based on simplistic tax assumptions, which lead to the conclusion that a traditional IRA is a better investment vehicle than a Roth IRA. Frequently an assumption is made that a person will be in a lower tax bracket during retirement when taking distributions than the pre-retirement tax bracket they are currently in while working and making contributions. Such a conclusion should not be assumed. Recommendations are often determined using calculations in which only the marginal tax rate is applied to the distribution itself and no consideration is made on the potential for additional taxation of SS benefits, and no consideration is made that the distribution may drive the individual into a higher income tax bracket. Projecting tax rates at retirement that are lower than may actually occur may create a false sense of security for a person and result in lower retirement investment than necessary to maintain the subsequent retired persons standard of living.

Yahoo internet search results for "IRA tax calculator" gave calculators with starting assumptions that current tax rates are higher than what future retirement tax rates will be (i.e. 27% currently and 15% in retirement) and none of the calculators factored in SS benefit taxation or mentioned the possibility that IRA distributions may create a higher effective tax bracket[2]. Although a person using the calculator could manually change the tax rate, the implication is that tax rates will be lower in retirement than pre-retirement.

[1] This table is used for unmarried owners, married owners whose spouses are not more than 10 years younger and married owners whose spouses are not the sole beneficiaries of their IRAs.

[2] http://www.amica.com/life_insurance/calcs/RegularIRA.html
http://www.idxsearch.com/calculators/java/RegularIRA.html

Current Research Assumptions

Our research challenges the assumption that a traditional IRA distribution will only create tax on the distribution alone, and that a person will normally be in a lower tax bracket when they retire. This research assumes that a person has contributed to a traditional IRA for many years, is now retired and is subject to the MRD rules. The person is single, has interest income, a pension, SS benefits, and IRA distributions. The IRA distribution amounts will vary in the examples and the incremental tax caused by varying traditional IRA distributions will be analyzed.

Tax rates while making contributions (the contribution years) are independent of the tax rate while receiving MRDs (the distribution or retirement years). However one could state a general causal relationship indicating that a person in a higher marginal tax bracket due to high taxable income during the contribution years (allowing for larger taxable and tax deferred investments, pension plans, and SS benefits) may be in a higher tax bracket during the distribution years as a result of the larger amount of taxable benefits. A person in a lower tax bracket during the contribution years may likewise be in a lower bracket during the distribution years due to a smaller amount of taxable benefits during retirement. The tax laws which change frequently may make current assumptions erroneous. Also, a low income frugal and wise (or lucky) investor in a lower tax bracket during the contribution years may end up in a higher tax bracket during the distribution years than a "normal" person.

Taxation of Social Security Benefits

Prior to 1984, SS benefits were not subject to federal income taxation. In 1984 Congress passed legislation which caused some taxpayers to pay income tax on a portion of their SS benefits. The formula calculated taxable benefits as the lesser of: one-half (50%) of benefits; or one-half (50%) of the excess of the taxpayer's provisional income over thresholds of $25,000 (single) and $32,000 (married couple), referred to as the Tier 1 threshold. Provisional income was defined as total income *plus* certain tax-exempt income (tax-exempt interest) *plus* certain income exclusions *plus* one-half (50%) of SS benefits. At the same time, the tax credit for the elderly and disabled was expanded to provide additional tax relief for lower income elderly taxpayers.

President Clinton proposed (as part of his FY1994 budget proposal) that the portion of SS benefits subject to taxation be increased from 50% to 85%, effective in tax year 1994. A second threshold (Tier 2) for taxation of 85% of SS benefits begins at $34,000 (single) and $44,000 (married couple). Therefore, presently up to 85 percent of SS benefits may be included in taxable income if a taxpayer's income exceeds a certain amount. The calculation of the income tax on SS Benefits is explained in Table 1. Note that over time, a greater percentage of taxpayers are being subjected to income tax on SS benefits because the provisional income thresholds are not indexed for inflation and have not been raised by congress since originally established years ago.

This research will focus on the impact of IRA withdrawals on the federal taxation of SS benefits and net federal ("real" or effective) income tax rate. The taxation of SS benefits varies

among states, as shown in Table 2. State taxation is not factored into the calculations used in this paper, although such taxation may be important for planning purposes. Table 3 shows the Congressional Budget Office estimates of the number of SS beneficiaries, the number of beneficiaries impacted by the taxation of SS benefits, and the percent of beneficiaries impacted by taxation of benefits by level of income.

Research Results

A variety of examples will now illustrate the "real" or effective tax effect of traditional IRA (or qualified 401k and 403b) distributions and demonstrate the importance of considering the impact of IRA withdrawals on the taxation of SS benefits.

Assumptions - IRA Account Owner
Marital Status: Single, Age 70, 2004 tax rates
Annual Income: Taxable interest and pension total $19,000, and (SS) benefits of $12,000 (all examples). IRA distribution amounts will differ.

The examples will demonstrate how differing amounts of traditional IRA distributions will impact the taxation of single individuals. The same impact would arise for married taxpayers at different income levels. Varying the provisional income (in these examples by changing the amount of IRA distributions) causes the "real" or effective tax rate to change in an amount greater than what many taxpayers and planners expect.

	Example 1	**Example 2**
Income		
Social Security	$12,000	$12,000
Interest & Pension	19,000	19,000
Traditional IRA	0	1,000
Net	19,000*	20,000
SS taxed	0	500
Net AGI	19,000	20,500
Taxable Inc.	9,850	11,350
Tax	$1,124	$1,349

(* Taxpayer's SS taxation begins - $19K + $6K (1/2 of SS benefit) = $25K Tier 1 limit)

Comparing examples 1 and 2 reveals that $1000 of extra taxable income from an IRA (or interest, pension, etc) not only causes the $1000 to be subject to tax, but also causes $500 of SS benefits to be taxed. This taxpayer is in the 15% federal income tax bracket; however, the additional $500 of SS benefit being subjected to tax creates an effective marginal federal tax rate on the $1000 of IRA distribution equal to 22.5% ($225 added tax divided by $1000 of additional IRA income).

Investment Principle #1 – once a taxpayer reaches the threshold causing 50 percent of their SS benefit to be taxed, the taxpayers marginal rate is 50 percent higher than the "normal federal

marginal rate". i.e. A taxpayer in a 15% bracket is taxed at 15% + 7.5% (50% of 15%) = 22.5% on each additional dollar of taxable income until the taxpayer reaches a new threshold of taxation.

Examples 3 and 4 will now demonstrate the tax effect of increasing the traditional IRA withdrawal to $9,000 and $10,000, respectively.

Example 3	**Example 4**	
Income		
Social Security	$12,000	$12,000
Interest & Pension	19,000	19,000
Traditional IRA	9,000	10,000
Net	28,000	29,000
SS taxed	4,500	5,350
Net AGI	32,500	34,350
Taxable Inc.	23,350	25,200
Tax	$3,149	$3,426

Comparing examples 3 and 4 reveals that $1000 of extra taxable income causes the $1000 to be subject to tax and $850 of SS benefits to be taxed. This taxpayer is in the 15% federal income tax bracket; however, the additional $850 of SS benefit being subjected to tax creates an effective marginal federal tax rate on the IRA distribution equal to 27.75% ($277 added tax divided by $1000 of additional IRA income).

Investment Principle #2 – once a taxpayer reaches the higher threshold causing 85 percent of their SS benefit to be taxed, the taxpayers marginal rate is 85 percent higher than the "normal federal marginal rate". i.e. A taxpayer in a 15% bracket is taxed at 15% + 12.75% (85% of 15%) = 27.75% on each additional dollar of taxable income until the taxpayer reaches a new threshold of taxation.

Examples 5 and 6 demonstrate increasing the traditional IRA withdrawal to $14,000 and $15,000, respectively.

Example 5	**Example 6**	
Income		
Social Security	$12,000	$12,000
Interest & Pension	19,000	19,000
Traditional IRA	14,000	15,000
Net	33,000	34,000
SS taxed	8,750	9,600
Net AGI	41,750	43,600
Taxable Inc.	32,600	34,450
Tax	$4,894	$5,336

Comparing examples 5 and 6 reveals that $1000 of extra taxable income from an IRA (or interest, pension, etc) of a taxpayer that has moved from the 15% federal income tax bracket into

the 25% bracket not only causes the $1000 to be subject to tax, but also causes $850 of SS benefits to be taxed in the higher marginal bracket. The year 2004 taxable income limit is $29,050 before moving a taxpayer from the 15% federal income tax bracket into the 25% bracket. (IRS Publication 17) This taxpayer is in the 25% federal income tax bracket; however, the additional $850 of SS benefit being subjected to tax creates an effective marginal federal tax rate on the $1000 of additional IRA distribution equal to 46.25% ($462 added tax divided by $1000 of additional IRA income).

Investment Principle #3 – once a taxpayer reaches the higher threshold causing 85 percent of their SS benefit to be taxed, the taxpayers marginal rate is 85 percent higher than the "normal federal marginal rate". Therefore, a taxpayer in a 25% bracket is taxed at 25% + 21.25% (85% of 25%) = 46.25% on each additional dollar of taxable income until the taxpayer reaches a new threshold of taxation.

Examples 6 and 7 will now demonstrate the tax effects of traditional IRA withdrawals of $15,000 and $16,000, respectively.

Example 6	**Example 7**	
Income		
Social Security	$12,000	$12,000
Interest & Pension	19,000	19,000
Traditional IRA	15,000	16,000
Net	34,000	35,000
SS taxed	9,600	10,200*
Net AGI	43,600	45,200
Taxable Inc.	34,450	36,050
Tax	$5,356	$5,756

* Maximum limit of $12,000 x 85% is reached.

Comparing example 6 and adding example 7 reveals that $1000 of extra taxable income from an IRA (or interest, pension, etc) of a taxpayer that has hit the 85% limit of SS benefit taxation begins to bring the "real" effective marginal rate back to the normal federal marginal income tax rate. In this comparison, the added IRA distribution of $1000 is subject to tax and causes $600 of SS benefits (reaching the 12,000 x 85% = $10,200 maximum of SS benefit taxation) to be taxed in the higher marginal bracket. This taxpayer is in the 25% federal income tax bracket; however, the additional $600 of SS benefit being subjected to tax creates an effective marginal federal tax rate on the $1000 of additional IRA distribution equal to 40% ($400 added tax divided by $1000 of additional IRA income).

Examples 7 and 8 will now demonstrate the tax effects of traditional IRA withdrawals of $16,000 and $17,000, respectively.

	Example 7	**Example 8**
Income		
Social Security	$12,000	$12,000
Interest & Pension	19,000	19,000
Traditional IRA	16,000	17,000
Net	35,000	36,000
SS taxed	10,200*	10,200*
Net AGI	45,200	46,200
Taxable Inc.	36,050	37,050
Tax	$5,756	$6,006

* Maximum limit of $12,000 x 85% is reached.

Comparing example 7 with example 8 reveals that $1000 of extra taxable income from an IRA (or interest, pension, etc) of a taxpayer that is over the 85% maximum limit of SS benefit taxation returns to the normal federal marginal income tax rate. In this comparison, the added IRA distribution of $1000 is subject to tax and causes no added taxation of SS benefits (having reached the 12,000 x 85% = $10,200 maximum of SS benefit taxation). This taxpayer will remain in "the normal 25% federal income tax bracket (until moving to the 28% marginal bracket at a taxable income level of $70,350 for tax year 2004). The $1000 of additional IRA distribution is taxed at 25% ($250 added tax divided by $1000 of additional IRA income).

Investment Principle #4 – once a taxpayer reaches the maximum threshold causing inclusion of 85 percent of their entire SS benefit to be taxed, the taxpayers marginal rate returns to the "normal federal marginal rate" which under current law would be a minimum of 25% for a single person.

Summary

The results clearly illustrate that taxable IRA distributions (or other taxable income) may raise a taxpayer into a much higher marginal tax rate, factoring the potential added taxation of SS benefits. Each taxpayer's situation is unique and planning decisions based on unknown investment returns, future tax laws and other variables complicates the planning process. This research reveals that financial advisors and taxpayers should be careful when making assumptions or concluding that a taxpayer will be in a lower tax bracket during retirement, when the exact opposite may occur. Currently, Roth IRAs are not includable in income for purposes of calculating the taxation of SS benefits; therefore, the above analysis may provide further evidence that such an investment vehicle should be considered when available for use by a taxpayer.

Table 1
Calculation of Taxable Social Security and Tier I Railroad Retirement Benefits
Provisional Income (*) Calculation of Taxable Social Security and Tier I Railroad Retirement Benefits

Single taxpayer Less than $25,000 No taxable Social Security or Tier I Railroad Retirement benefits $25,000 less than $34,000 Lesser of: (1) 50% of Social Security and Tier I benefits; or (2) 50% of provisional income above $25,000 More than $34,000 Lesser of: (1) 85% of Social Security and Tier I benefits; or (2) 85% of provisional income above $34,000 *plus* lesser of: (A) $4,500; or (B) 50% of Social Security and Tier I benefits *Married taxpayer* Less than $32,000 No taxable Social Security or Tier I Railroad Retirement benefits $32,000 less than $44,000 Lesser of: (1) 50% of Social Security benefits; or (2) 50% of provisional income above $32,000 More than $44,000 Lesser of: (1) 85% of Social Security benefits; or (2) 85% of provisional income above $44,000 *plus* lesser of: (A) $6,000; or (B) 50% of taxable Social Security benefits

Source: Congressional Research Service (CRS).
Note: Provisional income is total income plus certain income exclusions plus one-half (50%) of Social Security benefits.

Table 2.
State Income Taxation of Social Security Benefits, Tax Year 2003

States taxing all or part of the federal taxable Social Security benefits
Connecticut, Iowa, Kansas, Minnesota, Missouri, Montana, Nebraska, New Mexico, North Dakota, Rhode Island, Utah, Vermont, West Virginia, Wisconsin

States not taxing Social Security benefits
Alabama, Arizona, Arkansas, California, Colorado, Delaware, District of Columbia, Georgia, Hawaii, Idaho, Indiana, Illinois, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Mississippi, New Jersey, New York, North Carolina, Ohio, Oklahoma, Oregon, Pennsylvania, South Carolina, Virginia

States without a state personal income tax
Alaska, Florida, Nevada, New Hampshire*, South Dakota, Tennessee, Texas, Washington, Wyoming

Source: Congressional Research Service (CRS).
*New Hampshire does tax interest and dividend income.

Table 3. Number and Percentage of Beneficiaries with Taxable Social Security Benefits by Income Class Under 2003 Law, Population and Income at 2000 Levels

Level of income	# of SS beneficiaries (in 000s)	# of taxed (000s)	Percent taxed
Less than $10,000	7,157	2	0%
$10,000 - $15,000	4,845	7	0%
$15,000 - $20,000	3,509	12	0%
$20,000 - $25,000	3,439	22	1%
$25,000 - $30,000	2,854	360	13%
$30,000 - $40,000	5,225	2,237	43%
$40,000 - $50,000	3,918	3,598	92%
$50,000 - $100,000	6,705	6,608	99%
Over $100,000	2,737	2,723	100%
Total	40,389	15,569	39%

Source: Table prepared by the Congressional Research (CRS) from Committee on Ways and Means, 2004 Green Book, Background Material Within the Jurisdiction of the Committee on Ways and Means, Table 1-25, prepared by the Congressional Budget Office (CBO).

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