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Social Security COLA Could Have Surprising Tax Effects

Social Security taxation doesn't change with inflation, but tax brackets do. This can produce unusual results.

By **Joe Elsasser** | November 03, 2022

Social Security is a significant income stream for millions of retired Americans, so financial advisors must be able to calculate precisely how much clients will receive in monthly benefits once they turn 62.

The primary insurance amount (PIA) will increase yearly by the annual cost-of-living adjustment (COLA), which keeps Social Security payments in line with inflation. COLAs are applied to the PIA each year (https://www.thinkadvisor.com/2022/11/01/social-security-cola-what-clients-dont-know-could-lead-to-a-claiming-mistake/) beginning at age 62, even if an individual does not elect at that time. You can help clients understand how much they can expect to receive once the cost-of-living adjustments are applied to Social Security benefits.

High inflation over the past several months has led to the most significant cost-of-living increase since the 1980s. In 2023, Social Security benefits will increase by 8.7% (https://www.ssa.gov/news/press/releases/2022/?utm_content=pressrelease&utm_medium=email&utm_source=govdelivery#10-2022-2).

How Are COLAs Calculated?

Annual COLAs are determined by the change in the Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI–W), which the Bureau of Labor Statistics calculates. The average of the current year's third quarter is divided by the average of the third quarter for the prior year and rounded to the nearest tenth of a percent to determine the figure.

The Social Security Administration annually publishes the cost-of-living adjustments in a Fact Sheet (//www.ssa.gov/news/press/factsheets/colafacts2023.pdf), which includes the rate for the new year and other relevant information about the Social Security program. The COLA is typically announced in October (https://www.thinkadvisor.com/2022/10/13/social-security-cola-for-2023-is-8-7-percent/). In December, beneficiaries receive a COLA notice from the Social Security Administration that explains their new benefit. The first check in January of the new year will include the new amount.

Social Security Taxation

The increase in Social Security benefits could affect how much your clients pay in taxes. Social Security benefits can become taxable when the beneficiary's "provisional income" exceeds specific thresholds established by the IRS. After the application of the formula, clients can end up paying taxes on up to 85% of their benefits at ordinary income tax rates.

The provisional income formula can be tricky. Provisional income includes half of their Social Security benefits (which will be more in 2023 due to the significant cost-of-living-adjustment), plus all other taxable income, such as dividends, realized interest, and realized capital gains. It also includes nontaxable interest earnings, like those from municipal bonds. The thresholds for taxable benefits are applied to the provisional income number, rather than the total.

Since only 50% of Social Security income is counted as provisional income, you might think that only 50% of the COLA would count against the client in determining taxable benefits. When you pair that with a roughly 7% increase in tax brackets for 2023 (https://www.thinkadvisor.com/2022/10/19/13-new-tax-numbers-to-know-for-2023/), you may be considering increasing IRA withdrawals by 7% to try to keep up with inflation, but the math doesn't work.

In spite of the fact that tax brackets are increased by inflation (though a different measure than Social Security benefits), the thresholds for determining taxable Social Security benefits are not increased, which produces some unusual results.

For example, a married couple with a $35,000 Social Security benefit in 2022 who withdrew the maximum from their IRA without paying any federal tax and is trying to follow the same strategy for 2023 could increase their IRA withdrawal by about 3.4% and get the same result. A couple with $80,000 of combined Social Security benefits would have to reduce their IRA withdrawal by 3.7% to achieve the same result. Clearly there is no rule of thumb here.

The key is evaluating every client's tax situation yearly to target the blend of withdrawals from various sources to keep the client's marginal tax rate at a level that fits their long-term financial strategy. Some financial planning software can do these calculations for you to make this process faster and easier.

Social Security benefits are a unique weapon in a financial advisor's arsenal because they are directly and immediately tied to inflation. Common wisdom holds that equity ownership is essential to outpacing inflation over time. Still, in periods of rising inflation, as we're seeing now, stocks don't move immediately with inflation and may even go backward. Bonds are no haven either since rising interest rates frequently mark inflationary periods.

Advisors who optimize Social Security as part of their planning strategy frequently recommend a higher concentration of Social Security income through the later years of retirement, providing a more robust inflation-adjusted and longevity protected income floor for their clients. The ability to explain and demonstrate the impact of inflation on Social Security benefits and the client's withdrawal strategy to produce after-tax income can help you create and retain clients for life.

Joe Elsasser is the founder and president of Covisum (http://covisum.com/), a financial technology company focused on creating software that improves lives through better financial decisions. Covisum helps financial advisors serving mass-affluent clients in or near retirement and powers some of the nation's largest financial planning institutions.

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