THE COMBINED EFFECTS OF SALES OF CAPITAL ASSETS AND THE TAX TREATMENT OF SOCIAL SECURITY BENEFITS: HOW CAN SENIORS PLAN?

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ABSTRACT

Many middle-income elderly Americans cannot possibly know what the effects of some common financial decisions are on their tax liability. Why? Because transactions that seem like they would have a predictable effect on their tax and after-tax cash flow, are far from predictable. The problem is that for those with gross incomes anywhere from the high teens (of thousands) to the fifties (and sometimes more), the phase-in of the tax on Social Security can have near random effects on the tax. The effective rates can range from 5 percent to over 30 percent, plus the effects of state and local income tax levies.

INTRODUCTION AND OVERVIEW

Social Security annuitants originally paid no income tax on their benefits. That changed in the mid-eighties (up to 50 percent could be taxed), with an increase (up to 85 percent can be taxed) in 1993. The taxable portion is based on what is called modified taxable income—it includes AGI before the Social Security, municipal bond interest, and one-half of the Social Security benefit to the extent the total exceeds a base amount. As a result, an increase in some other taxable income or tax-exempt municipal bond interest can cause more of the Social Security to be taxed.

An Example

During 2004, octogenarian Helen—aka Mom—became a little frustrated with one of her investment accounts that was totally invested in growth stocks. You see, the values of the growth stocks were not growing. They were supposed to grow.

So, Mom visited the new broker in town. The broker was a little reluctant to recommend selling, because moving the funds into the funds he would recommended would be taxable. But, he reasoned, it will only be taxed at 15 percent—the federal capital gains tax (there is no personal income tax in Texas).

Mom forgot the all important advice, always check with your tax advisor before undertaking a significant buy or sell decision. Surprise!!! These funds were purchased in the mid-eighties for $5,000. They grew for quite some time, before that stopped. When she sold them for $27,143, she had a long-term capital gain, subject to the 15% capital gains rate that was part of the last tax cuts.

The Surprise

The capital gains are included in income. The additional income made 85% more of Mom and Dad's Social Security benefits taxable. The tax on the Social Security benefits is at the regular rate—25% for Mom and Dad. Mom's $22,143 gain made $18,822 more of their Social Security taxable. The tax

increase is varied, because a gain of this size took Mom and Dad from the 15% bracket to the 25% bracket, which means that part of the capital gain was taxed at 5% and part at 15%. Part of the increase in the taxable Social Security was taxed at 15% and part at 25%. With detailed calculations (that will be part of the presentation), it can be demonstrated that there are four different effective marginal tax brackets in this example from 12.5% to 17.75% to 36.25% to 15%.

- The highest marginal effective tax—36.25%—occurs when the additional gain is in the 25% ordinary bracket, and therefore is subject to the 15% rate, and the additional taxable Social Security benefit is taxed at 25%. This is more than double what the broker thought it would be.
- The lowest marginal effective tax—12.5%—occurs when the additional gain is in the 15% ordinary bracket benefit, and therefore is subject to the 5% rate, and the additional taxable Social Security (which is phased in at a rate of 50% for married couples up to $32,000 of modified AGI) is taxed at 15% (due to the 50% taxability, the effective rate is 7.5%).
- Another marginal effective tax—17.5%—occurs when the additional gain is in the 15% ordinary bracket benefit, and therefore is subject to the 5% rate, and 85% of the additional Social Security is taxed at 15%.
- The final marginal effective tax on the gain—15%—occurs when the additional gain is in the 25% ordinary bracket, and therefore is subject to the 15% rate, and the additional taxable Social Security benefit is not taxed, because the maximum amount of Social Security has been taxed (i.e., 85% is the maximum amount of Social Security subject to taxation). Once a taxpayer reaches the point where the maximum amount of Social Security is taxed, the tax rate stabilizes and tax burdens become more predictable.

With more accurate information, Mom might have chosen to sell just part of the investment. Or, perhaps she would have sold part in 2003 and part in 2004. Or, she might have not sold at all. But more accurate information is seldom available until the year is closed, and planning opportunities have past.

Another Example

Rose Lipman, age 99, had some common shares of a company that did not pay a dividend. A neighbor, who was a tax and financial advisor, suggested that she sell the shares for the current market price of $15,000 and invest the proceeds in California municipal bonds paying interest at 3.9 percent and not subject to either federal or California income tax.

Because Rose had only paid $5,000 for the shares, she would have in include a $10,000 long term capital gain in her 2004 tax return, which the advisor assured her would cost her no more than a 15 percent federal tax or $1,500 (The California tax effects are not included in this example). Therefore, the advisor told Rose, "by making this investment change, you will have additional after tax spendable income of 3.9 percent of $13,500, or $526.50.

When Rose prepared her 2004 federal income tax return, she was surprised when her tax went up $3,293 because of the gain instead of the $1,500 she had been expecting. Therefore, the $10,000 long term capital gain had been effectively taxed at 32.9 percent instead of 15 percent. The details are presented below.

Because Rose was very healthy and she loved her job, she did not retire until age-70 when she received a lifetime pension of $25,000 per year. Also, she delayed starting her social security retirement benefit until age 70 which increased the amount she received each month by about 40 percent over the amount

she would have received at age-65. Therefore, in 2004, her income and tax liability without the capital gain would have been as follows:

	Gross Income	Taxable
Pension	$25,000	$25,000
Social Security Benefits	30,000	9,600
Total	$55,000	$34,600
Standard Deduction		(5,800)
Personal Exemption		(3,100)
Taxable Income		$25,700
Federal Income Tax		$ 3,501

What Rose (and the financial advisor) had not considered was that the increase in modified adjusted gross income (AGI) caused by the capital gain would increase the taxable amount of her Social Security benefit for the year. Therefore, her 2004 income and federal income tax liability are illustrated as follows:

	Gross Income	Taxable
Long Term Capital Gain	$10,000	$10,000
Pension	25,000	25,000
Social Security Benefits	30,000	18,100
Total	$65,000	$53,100
Standard Deduction		(5,800)
Personal Exemption		(3,100)
Taxable Income		$44,200
Federal Income Tax		$ 6,794

Therefore, the increase in federal income tax, caused by the capital gain, was $6,794 less $3,501 or $3,293. The effective rate is 32.93 percent of the $10,000 gain instead of 15 percent.

POLICY AND PLANNING

Many seniors deal with this and similar issues. In the short run, they need to be informed, as a group, that they need to consult their tax advisor before selling anything that might result in a significant gain. In a situation like Mom's, a competent advisor could explain that, unless the growth effectively stops permanently, the 36.25 percent (or one of the other effective marginal rates) tax reduces her capital available to produce returns, her future earnings will be on 63.75 percent (or other applicable percentage) of her prior base. As a second step, seniors need to be educated as to the effect that their Social Security may result in this or similar complex, seemingly inequitable, tax burdens. They, then, as a group, can decide whether to hold the Congress responsible.

CONCLUSION

This paper is a first step in research intended to educate seniors, using this simple example and others, as to their complex situations. The goal at this point and at this conference is to establish the specific goal(s) of additional research and to explore effective ways to accomplish it (them).