A RETIREMENT INSTITUTE GUIDE

Social Security: From Taxable to *Tax-Efficient*

The hidden tax on your benefits — how it's calculated, and the two retirement tools that can legally make it disappear.

WELCOME

Knowledge first.
Always.

The Retirement Institute exists to help Americans approaching and living in retirement make clear, confident, well-informed financial decisions — without the pressure of a sales pitch.

This is the second guide in our Tax-Free Retirement Series, a growing library of educational resources built to put real knowledge — and real control — back in your hands.

Most people assume the taxation of their Social Security is simply a fact of life — something that happens *to* them. It isn't. How much of your benefit the IRS can reach is determined by a single, controllable number. And there are exactly two retirement tools that don't count toward it.

This guide explains how the tax works, what feeds it, and how some retirees legally collect a six-figure income while paying nothing on their Social Security. The point isn't a trick. It's a design — one made on purpose, usually years in advance.

BEFORE YOU BEGIN

This guide is for general education only. It is not personalized financial, tax, or legal advice, and no advisor-client relationship is created by reading it. Tax thresholds and rules change, and the right approach depends on your circumstances. Please consult a qualified tax or financial professional before acting. (Full disclosures appear at the end.)

INTRODUCTION

The tax most retirees never *see coming*

You paid into Social Security your entire working life with after-tax dollars. So it surprises many people to learn that up to **85% of their benefit** can be pulled back into their taxable income in retirement — taxed a second time, at their ordinary rate.

Here's the good news hiding inside that bad news. The taxation of Social Security isn't random, and it isn't fixed. It's driven by one figure — your **provisional income** — and that figure is largely a product of *where your retirement income comes from*, not just how much you have.

That distinction is everything. Two retirees can spend the exact same amount each year, yet one has up to 85% of their Social Security taxed and the other pays nothing — because of which "buckets" their income flows from.

In the pages ahead, we'll cover three things: how the tax is calculated, the surprisingly long list of income that feeds it, and the only two retirement tools that don't. Then we'll show it in action.

> No matter how high your income, the law caps the taxable portion of your benefit at **85%** — which means at least **15% of your Social Security is always tax-free**. The goal of smart planning is to push that tax-free share as close to 100% as your situation allows.

NUMBER 1

01

How your Social Security gets taxed

Social Security taxation works in tiers. As your provisional income (defined on the next page) rises past certain thresholds, a larger share of your benefit gets folded into your taxable income:

Tier 1

None taxable

Provisional income under **$25k** (single) or **$32k** (married filing jointly). Your benefit is fully tax-free.

Tier 2

Up to 50%

Between **$25k–$34k** (single) or **$32k–$44k** (joint). Up to half your benefit becomes taxable.

Tier 3

Up to 85%

Above **$34k** (single) or **$44k** (joint). Up to 85% of your benefit is pulled into taxable income.

Two details matter enormously. First, these thresholds have **never been adjusted for inflation** — set in the 1980s and 1990s, they ensnare more retirees every year. Second, "up to 85%" is a ceiling, not a rate: it means up to 85 cents of every benefit dollar is *added to your taxable income* and taxed at your ordinary bracket. The other 15 cents are always yours, tax-free.

> *The question isn't whether your benefit is taxable. It's how much of it you allow to become taxable.*

NUMBER 2

02

Provisional income: the number that decides everything

Provisional income is the IRS's measuring stick for taxing your benefit. The formula is deceptively simple:

Adjusted Gross Income + tax-exempt interest + ½ of your Social Security

The trap is in how broad that first piece is. Nearly every dollar of income you can name lands in provisional income:

- Wages and self-employment income
- Distributions and RMDs from Traditional IRAs, 401(k)s, and 403(b)s
- Pension and annuity income
- Interest, dividends, and capital gains
- Rental, royalty, and most business income
- **Even tax-exempt municipal bond interest** — "tax-free" on its own, yet it still counts here

...plus one-half of your gross Social Security. That muni-bond line catches people off guard every year: a bond marketed as "tax-free" can still drag your Social Security into taxation. Almost everything counts.

> *If it shows up on your tax return as income — and even some things that don't — it probably feeds provisional income.*

NUMBER 3

03

The only two dollars that don't count

If almost every source of income raises your provisional income, the path to a tax-free benefit is to fund retirement from the few that don't. There are essentially two:

- **Roth accounts (Roth IRA / Roth 401(k)).** Qualified Roth withdrawals are income-tax-free and are *excluded from Adjusted Gross Income* entirely. They never enter the provisional-income formula.
- **Properly structured cash-value life insurance** — sometimes called a Life Insurance Retirement Program, or LIRP. Income can be accessed through withdrawals up to your basis and policy loans, which generally are not treated as taxable income — so they don't raise provisional income either.

This is why these two tools are the cornerstones of tax-free retirement income. A dollar spent from a Traditional IRA can tax your Social Security; the same dollar spent from a Roth or a properly structured policy generally does not. Same lifestyle, very different tax outcome.

> *It's not how much income you have. It's whether that income is visible to the formula.*

IN PRACTICE · CASE STUDY ONE

A six-figure income, a *zero-tax* benefit

The Hendersons (married, filing jointly) spend about **$120,000** a year in retirement — a comfortable, six-figure lifestyle. Years ago, they deliberately built their retirement around tax-free sources:

- **$50,000** from Social Security
- **$45,000** from Roth accounts
- **$25,000** from a properly structured cash-value policy (LIRP)

Their total income is far above the $44,000 joint threshold. By the old assumption, up to 85% of their Social Security would be taxable. But watch what happens to the formula:

CASE STUDY · HYPOTHETICAL · THE HENDERSONS' PROVISIONAL INCOME

AGI from Roth + LIRP withdrawals: **$0** (excluded) + tax-exempt interest: **$0** + ½ of Social Security: **$25,000**

PROVISIONAL INCOME	SOCIAL SECURITY TAXED
$25,000	$0
below the $32k joint threshold	100% of the benefit is tax-free

Because their Roth and policy income never enters Adjusted Gross Income, their provisional income lands below the first threshold. The result: a $120,000 lifestyle, half of it from Social Security, and **not one dollar of that Social Security is taxed**. Had those same withdrawals come from a Traditional IRA instead, their provisional income would have exceeded $90,000 — exposing up to 85% of their benefit to tax on top of the fully-taxable IRA income.

> *Same spending. Same Social Security. The only difference was the bucket the rest of the money came from.*

IN PRACTICE · CASE STUDY TWO

When you can't reach zero — but you still win *big*

Not everyone can get to a fully tax-free benefit. Diane has a **$40,000 pension** she can't reposition — and pension income counts toward provisional income, so some of her Social Security will always be taxable. That doesn't mean planning can't help. It means the goal shifts from *elimination* to *reduction*.

In her original setup, Diane covered her remaining expenses with large Traditional IRA withdrawals. After repositioning — converting to Roth in lower-income years and drawing discretionary income from Roth and a policy — only the unavoidable pension drives her provisional income.

CASE STUDY · HYPOTHETICAL · ILLUSTRATIVE TAX OUTCOME ON DIANE'S BENEFIT

BEFORE	AFTER
~85%	~20%
of her benefit taxable · 24% bracket	of her benefit taxable · 12% bracket

Two things improved at once. The *share* of her Social Security exposed to tax fell sharply, and the *rate* applied to her income dropped a full bracket as her taxable income came down. Less of her benefit is taxed — and what remains is taxed far more gently.

Even a partial victory like this can be worth thousands of dollars a year, every year, for the rest of her life. And it's worth saying plainly:

> *This doesn't happen by accident. It happens on purpose.*

THE BOTTOM LINE

Tax-free isn't luck. It's design.

The taxation of your Social Security is not a fixed cost handed down from on high. It's the output of a formula — and you have far more influence over the inputs than most people realize.

The lever is provisional income. Nearly every source of retirement income raises it; only two retirement tools — Roth accounts and properly structured cash-value life insurance — sit outside it. The more of your income you can shift into those tools, the less of your Social Security the IRS can reach. For some, that means a benefit taxed at zero. For others, it means dropping from the 85% maximum down to a fraction of that, at a lower bracket. Both are wins worth engineering.

TWO HONEST QUESTIONS WORTH SITTING WITH

— *Do you know what share of your Social Security is currently exposed to tax — and why?*

— *How much of your future income is positioned in the only two buckets that don't count against you?*

This guide pairs naturally with its companion, *8 Keys to Roth Conversions*, which covers *how* to move money into the tax-free column in the first place. Seeing the whole board — and building a plan around your numbers — is a conversation worth having with a qualified professional.

About The Retirement Institute

The Retirement Institute is a non-profit dedicated to financial education for Americans approaching and living in retirement. We publish clear, unbiased guides on the decisions that matter most — taxes, income, healthcare costs, and legacy — so that families can act from knowledge rather than fear. We don't sell products. We teach.

IMPORTANT DISCLOSURES

This guide is provided by The Retirement Institute for general educational purposes only. It does not constitute, and should not be relied upon as, personalized financial, investment, tax, insurance, or legal advice, and it does not create any advisor-client or fiduciary relationship. The case studies are hypothetical, simplified for illustration, do not reflect any specific individual's situation, and are not a guarantee of future results. The "before/after" tax outcomes shown are illustrative; actual taxation of Social Security is determined by an IRS formula and depends on your full income picture.

Provisional-income thresholds and the taxation of benefits are set by federal law and are subject to change; as noted, the thresholds are not currently indexed for inflation. The Social Security Administration (ssa.gov) and a qualified tax professional are the authoritative sources for your situation.

"LIRP" refers to a properly structured cash-value life insurance policy. Tax-free access via withdrawals to basis and policy loans depends on the policy remaining in force and not becoming a Modified Endowment Contract (MEC); loans and withdrawals reduce the death benefit and cash value, and a lapse may trigger taxes. Such policies involve fees, charges, and qualification requirements and are not suitable for everyone. Guarantees are subject to the claims-paying ability of the issuing insurer. Roth qualified-distribution rules (including the 5-year rule and age 59½) apply.