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Social Security income and the equivalent railroad retirement benefits used to be tax free --- but as many drawing those benefits today can attest, that's no longer the case. The taxable portion of benefits is a function of the recipient's income, and therein lies the secret for controlling the amount of taxes paid on the benefits.

To find out if your benefits are taxable, compare the base amount for your filing status with the total of (1) all of your other income, including tax-exempt interest, plus (2) one-half of your benefits. When making this calculation, keep in mind your income cannot be reduced by income excluded from U.S. savings bonds, foreign earned income or foreign housing, or income earned in American Samoa or Puerto Rico by bona fide residents.

There are two base amounts to be concerned about:

n \$25,000 and \$34,000: If you are single, the head of a household, a qualifying widow or widower, or married and filing separately after living apart from your spouse for all of 2003.

n \$32,000 and \$44,000: If you are married and filing a joint return.

To see how this works, let's take the case of a married couple filing a joint return. The couple's income from pensions is \$20,000, and they also have \$10,000 from dividends and tax-exempt interest. Their Social Security benefits total \$20,000. We add one-half of the SS benefits to the total income, equaling \$40,000. This exceeds their base amount of \$32,000 by \$8,000. Since half of the excess is less than half of their Social Security income, the couple will be taxed on \$4,000 of their Social Security income.

It could be worse. If the couple's income in the above calculation plus one-half of their Social Security benefits were greater than \$44,000, or the second base amount, then 85 percent of their Social Security income would be added to their taxable income calculation.

The trick to avoiding extra taxation, if your income level puts you close to your base amounts, is to control income sources.

For example, if you do not need the extra dividend interest, you can defer recognition of income by investing in U.S. savings bonds. Generally, the increase in value of the bonds issued at a discount (Series E and EE) is not taxable until you surrender the bonds.

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Tax deferred annuities provide the benefits above plus additional benefits. Money invested in a tax deferred annuity grows tax deferred and is not recognized in the calculation of income for Social Security taxation purposes. If the earnings are withdrawn, the income is taxable. However, by electing to annuitize the annuity at a later date, the owner will receive a guaranteed payment that is partially taxable, representing interest earned, and partially tax-free, representing principal.

Another strategy might be to alternate years of income recognition. For example, if your plan calls for liquidating investments from your portfolio, in one year you might sell those with little or no gain, thereby keeping your income down, while in a subsequent year, you could sell several positions with gains and pay higher taxes for that year.

The computations for determining the taxability of Social Security income are obviously complicated. The IRS provides "Publication 915" to walk you through the process. You can also find a directory of easy-to-access tax forms at www.hrblock.com. Social Security calculation information is in the Form 1040 package.

WALL ON THE STREET

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