

# FIVE HIDDEN RETIREMENT TAXES

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## OVERVIEW

In the Beatles' 1966 song "Taxman," we hear a musical story about a merciless government's mission to levy taxes on just about everything: the street, your seat, the heat, and even your feet. Although the U.S. government does not go as crazy as the song suggests when it comes to taxes, there is still a long list of taxes that Uncle Sam forces us to deal with. Income taxes, sales taxes, excise taxes, payroll taxes, estate taxes, and gift taxes are all examples that come to mind. However, there are a few "hidden" taxes lingering out there, especially for retirees. Some of these are taxes that are not always labeled as "taxes," but each one most certainly counts as tax. The purpose of this month's guide is to outline five of these hidden retirement taxes.

### 1. Medicare Premiums

The first hidden retirement tax we will explore is the infamous Medicare premium. Approximately 99 percent of Medicare beneficiaries do not have a Part A premium since most people have already paid into the system in the form of Medicare payroll withholdings (there is a Medicare Part A inpatient hospital deductible of \$1,408, so Part A is not entirely free)<sup>1</sup>. On the flip side, every Medicare beneficiary must pay a Part B premium. Part B premiums are adjusted annually in accordance with the Social Security Act, and the 2020 premium amounts are higher than the 2019 amounts (the premium increase is the result of rising spending on physician-administered drugs)<sup>1</sup>. Medicare premium calculations are based on your income. The following chart outlines 2020 Part B total premiums for beneficiaries with "high incomes"<sup>1</sup>:

Beneficiaries who file individual tax returns with income:	Beneficiaries who file joint tax returns with income:	Income-related monthly adjustment amount	Total monthly premium amount
Less than or equal to \$87,000	Less than or equal to \$174,000	\$0.00	\$144.60
Greater than \$87,000 and less than or equal to \$109,000	Greater than \$174,000 and less than or equal to \$218,000	\$57.80	\$202.40
Greater than \$109,000 and less than or equal to \$136,000	Greater than \$218,000 and less than or equal to \$272,000	\$144.60	\$289.20
Greater than \$136,000 and less than or equal to \$163,000	Greater than \$272,000 and less than or equal to \$326,000	\$231.40	\$376.00

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Beneficiaries who file individual tax returns with income:	Beneficiaries who file joint tax returns with income:	Income-related monthly adjustment amount	Total monthly premium amount
Greater than \$163,000 and less than or equal to \$500,000	Greater than \$326,000 and less than \$750,000	\$318.10	\$462.70
Greater than or equal to \$500,000	Greater than or equal to \$750,000	\$347.00	\$491.60

The next chart outlines 2020 Part B premiums for high-income beneficiaries who are married and lived with their spouse at any time during the taxable year, but file a separate return<sup>1</sup>:

Beneficiaries who are married and lived with their spouses at any time during the year, but who file separate returns from their spouses:	Income-related monthly adjustment amount	Total monthly premium amount
Less than or equal to \$87,000	\$0.00	\$144.60
Greater than \$87,000 and less than \$413,000	\$318.10	\$462.70
Greater than or equal to \$413,000	\$347.00	\$491.60

Note that the Social Security Administration automatically deducts your Medicare Part B premium from your monthly benefit<sup>2</sup>, so you never truly stop paying the Medicare tax even after you retire.

## 2. The Medicare Surtax

Try not to be too surprised, but the federal government imposes an extra Medicare tax levy of 3.8 percent on any investment income above a certain threshold from your own investments or from an estate or a trust<sup>3</sup>. This Medicare surtax is formally known as the Net Investment Income Tax (NIIT), and it went into effect on January 1, 2013<sup>3</sup>. According to the IRS, individuals will owe the NIIT if they have net investment income (and modified adjusted gross income) over the following thresholds<sup>3</sup>:

Filing Status	Threshold Amount
Married filing jointly	\$250,000
Married filing separately	\$125,000
Single	\$200,000
Head of household (with qualifying person)	\$200,000
Qualifying widow/widower with dependent child	\$250,000

It is important to know what is included in calculations of net investment income. According to the IRS<sup>3</sup>, “In general investment income includes, but is not limited to: interest, dividends, capital gains, rental and royalty income, non-qualified annuities, income from businesses involved in trading of financial instruments or commodities and businesses that are passive activities to the taxpayer.” Common types of income that do not factor into net investment income calculations include wages, unemployment compensation, operating income from a nonpassive business, Social Security benefits, alimony, tax-exempt interest, self-employment income, and

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distributions from certain qualified plans<sup>3</sup>. However, if you have investment income from any of the instruments outlined above in excess of the threshold that applies to your tax situation, you will probably have to pay the 3.8 percent Medicare surtax. This could be a significant expense during your retirement years, especially if you are a high-net-worth investor.

### 3. Social Security Taxes

If you have “other substantial income” in addition to your Social Security benefits (examples include wages, self-employment, interest, dividends, and other taxable income that must be reported on your tax return), you could have to pay federal income taxes on those benefits<sup>4</sup>.

**Note:** In the next paragraph, your “combined income” is calculated using this formula<sup>4</sup>:

Your adjusted gross income  
 + Nontaxable interest  
 + ½ of your Social Security benefits  
 = Your “combined income”

According to the Social Security Administration<sup>4</sup>, “If you file a federal tax return as an ‘individual’ and your combined income is between \$25,000 and \$34,000, you may have to pay income tax on up to 50 percent of your benefits.” However, if your combined income is more than \$34,000, you may have to pay income tax on up to **85 percent** of your benefits<sup>4</sup>.

What happens if you file a joint return? In this scenario, if you and your spouse have a combined income that is between \$32,000 and \$44,000, you could be forced to fork over income tax on up to 50 percent of your benefits<sup>4</sup>. If your combined income is higher than \$44,000, (you guessed it!) up to **85 percent** of your benefits may be taxable<sup>4</sup>.

Yes, you read the number correctly: 85 percent of your Social Security benefits could be taxable if your income is high enough. Keep in mind that your benefits are still taxed at regular income tax rates based on your tax bracket. Consult with your financial advisor if you have questions about how your income might affect the taxation of your Social Security benefits.

### 4. The Widow’s Penalty

The so-called “widow’s penalty” is a prominent conflict that exists in the federal tax code. Tax rates for married couples filing joint returns are significantly more generous than tax rates for single people. This becomes a problem in retirement for anyone who loses a spouse. If your spouse passes away, you could experience a sudden and unexpected increase in your income tax liability because of the conflict. Take a quick look at the 2020 federal income tax brackets and rates<sup>5</sup>:

Rate	For single individuals, taxable income over	For married individuals filing joint returns, taxable income over	For heads of households, taxable income over
10%	\$0	\$0	\$0
12%	\$9,875	\$19,750	\$14,100

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Rate	For single individuals, taxable income over	For married individuals filing joint returns, taxable income over	For heads of households, taxable income over
22%	\$40,125	\$80,250	\$53,700
24%	\$85,525	\$171,050	\$85,500
32%	\$163,300	\$326,600	\$163,300
35%	\$207,350	\$414,700	\$207,350
37%	\$518,400	\$622,050	\$518,400

Now, let's say that the taxable income you and your spouse receive in retirement (for instance, withdrawals from retirement plans, pension income, investment income in non-retirement accounts, and/or withdrawals from an annuity) amounts to \$41,000. Let's also say that you and your spouse file a joint return. In this scenario, your tax rate would be 12 percent. However, if your spouse passes away, you would be able to file as married filing jointly only for the year in which your spouse's death occurred<sup>6</sup>. After that year, you would have to file as a single person. If your income is still \$41,000 the next year, your tax rate would be 22 percent. This tax rate increase of ten percent is the widow's penalty.

## 5. The Hidden Costs of Selling Your Home

Do you plan on selling your primary residence once you retire? If you do end up selling your home, you might have to pay taxes if you have a capital gain. This potential liability depends on your tax situation and the actual amount of the gain. According to the IRS<sup>7</sup>, "If you have a capital gain from the sale of your main home, you may qualify to exclude up to \$250,000 of that gain from your income, or up to \$500,000 of that gain if you file a joint return with your spouse."

However, there is an additional consideration to keep in mind. Let's say that you bought your three-story brick Victorian duplex in Brookline, Massachusetts, for \$25,000 in 1971. Let's also say that the property is now worth \$2.2 million and sells for that amount, meaning that your capital gain would be approximately \$2.18 million. The IRS allows you and your spouse to exclude up to \$500,000 of that gain from your income, which is all well and good, but you will also have to deal with a substantial tax liability. Keep in mind that higher tax liabilities impact every tax that was previously outlined in this publication. In this scenario, the married couple would have to pay higher Medicare premiums, fork over the Medicare surtax, and see 85 percent of their Social Security benefits subjected to taxation. Of course, not every retiree will have to deal with the same exact scenario. However, it could not be more important to consult with your financial advisor before selling your home during your retirement years in order to understand how the sale will impact the other aspects of your financial situation.

## CONCLUSION

Retirement is full of financial pitfalls. The five taxes outlined in this guide that tend to be overlooked are just a few key examples. As with every financial consideration, it could not be more important for retirees to partner with a financial advisor to develop a strategy designed to get ahead of the pitfalls. This is especially true if you are a do-it-yourself investor. While the task of managing an investment portfolio might be easy to do on your own, it is just one of many components of a comprehensive retirement strategy. If you realize that you need a plan, an advisor from the Armstrong Advisory Group is ready to chat with you about your financial needs and answer any questions that you have. Consider scheduling a complimentary, no-obligation consultation today to discuss your financial situation and formulate a plan that will meet your needs in retirement.

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If you have at least \$400,000 in investable assets and would like to sit down with one of the Armstrong Advisory Group's financial advisors to discuss your investment needs, call (800) 393-4001 to schedule a complimentary, no-obligation financial consultation at an office near you. We have offices located throughout Massachusetts, New Hampshire, Rhode Island, and Connecticut.

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### ADDITIONAL INFORMATION

<sup>1</sup> <https://www.cms.gov/newsroom/fact-sheets/2020-medicare-parts-b-premiums-and-deductibles>

<sup>2</sup> <https://www.aarp.org/retirement/social-security/questions-answers/medicare-premiums-deducted-ss.html>

<sup>3</sup> <https://www.irs.gov/newsroom/questions-and-answers-on-the-net-investment-income-tax>

<sup>4</sup> <https://www.ssa.gov/planners/taxes.html>

<sup>5</sup> <https://taxfoundation.org/2020-tax-brackets/>

<sup>6</sup> <https://www.irs.gov/publications/p17>

<sup>7</sup> <https://www.irs.gov/taxtopics/tc701>

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