

# The Retirement Tax Trap

How Provisional Income Could Cost You Thousands in Social Security Benefits — and the Three Buckets That Trigger It

**The Provisional Income Formula**  
*It's not just your Social Security — it's the combination of ALL your income sources that triggers the tax*

| TAX BRACKET | TIPS  | + Distributions   | + Pensions  | + Rental Income   | + % Social Security | = Provisional Income |
|-------------|---|---|---|---|---------------------|----------------------|
| 37%         | <p><b>TAXABLE</b></p> <ul style="list-style-type: none"> <li>• Brokerage accounts</li> <li>• Dividends &amp; interest</li> <li>• Capital gains</li> <li>• Municipal bond interest*</li> </ul> <p>*SIF counts in formula</p> | <p><b>TAX-DEFERRED</b></p> <ul style="list-style-type: none"> <li>• Traditional IRA</li> <li>• 401(k) / 403(b)</li> <li>• RMDs (age 73+)</li> <li>• Annuity income (taxable portion)</li> </ul> <p>RMDs are mandatory — no choice</p> | <p><b>TAX-FREE</b></p> <ul style="list-style-type: none"> <li>• Roth IRA / Roth 401(k)</li> <li>• Life insurance cash value</li> <li>• HSA (qualified use)</li> <li>• Principal return</li> </ul> <p>Does NOT count toward Provisional Income</p> | <p><b>SS</b></p> <p>% of Annual Benefits</p> <p><b>50%</b></p> <p>counts toward formula</p> |                     |                      |
| 35%         |   |   |   |   |                     |                      |
| 32%         |   |   |   |   |                     |                      |
| 24%         |   |   |   |   |                     |                      |
| 22%         |   |   |   |   |                     |                      |
| 12%         |   |   |   |   |                     |                      |
| 10%         |   |   |   |   |                     |                      |

Married: under 22K = 0% | 22K-44K = up to 50% | Over 44K = up to 85% taxable SS

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# The Silent Tax on Your Retirement

Most Americans spend their entire working lives paying into the Social Security system, assuming that when it comes time to collect, those benefits will be theirs to keep — tax-free.

Unfortunately, for many retirees, that assumption is a costly mistake. Depending on how you generate income in retirement, **up to 85% of your Social Security benefits could be subject to federal income tax.**

Here is what most people don't realize: **it's not just your Social Security that triggers the tax.** It's the combination of all your other income sources — your investments, your retirement accounts, your pension — that pushes your Social Security into the taxable zone. The Social Security benefit itself is almost never the problem. **The problem is everything else sitting alongside it.**

The IRS uses a specific, often misunderstood formula to determine exactly how much of your benefit is taxable. It is called the **Provisional Income** formula. And it draws from three distinct buckets of retirement income.

## The Three Buckets of Provisional Income

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To calculate your Provisional Income, the IRS adds up income from three distinct buckets — then adds half of your Social Security benefit on top. Every dollar flowing into your retirement from any source gets counted.

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#### TAXABLE BUCKET

### 1099 Investment Income

Any income that generates a 1099 at tax time from your non-retirement, taxable accounts:

- › Interest income from savings accounts, CDs, or bonds
- › Dividend income from stocks or mutual funds
- › Capital gains from selling investments
- › **Municipal bond interest** — even though muni interest is generally tax-exempt, the IRS still counts it in this formula

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#### TAX-DEFERRED BUCKET

### IRA, 401(k) & RMD Distributions

Every dollar you withdraw from a tax-deferred retirement account counts toward Provisional Income:

- › Traditional IRA distributions
- › 401(k) or 403(b) distributions
- › **Required Minimum Distributions (RMDs)** — mandatory starting at age 73; you have no choice but to take them, and every dollar flows directly into this bucket

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#### GUARANTEED INCOME BUCKET

### Pension, Rental & Annuity Income

Income from guaranteed or contractual sources — fixed, predictable, and fully counted every year:

- › Pension payments from a former employer or government pension
- › Annuity income (taxable portion of non-qualified annuities)
- › Rental income from real estate holdings
- › Part-time wages or self-employment income

## The Full Formula

Once you add up all three buckets, you add half of your annual Social Security benefit. That final number is your Provisional Income.



The three income buckets that determine your Provisional Income — and your Social Security tax exposure

PROVISIONAL INCOME =

|          |   |
|----------|---|
| BUCKET 1 | Taxable Investment Income (1099s)                       |
| +        | BUCKET 2 Tax-Deferred Distributions (IRA / 401k / RMDs) |
| +        | BUCKET 3 Pension / Rental / Guaranteed Income           |
| +        | 50% SS Half of Your Annual Social Security Benefit      |
| = RESULT | <b>Your Provisional Income</b>                          |

The IRS then compares your Provisional Income against two thresholds to determine how much of your Social Security is taxable:

| Filing Status                     | Provisional Income  | Social Security Taxed |
|-----------------------------------|---------------------|-----------------------|
| <b>Single / Head of Household</b> | Under \$25,000      | <b>0%</b>             |
|                                   | \$25,000 – \$34,000 | <b>Up to 50%</b>      |
|                                   | Over \$34,000       | <b>Up to 85%</b>      |
| <b>Married Filing Jointly</b>     | Under \$32,000      | <b>0%</b>             |
|                                   | \$32,000 – \$44,000 | <b>Up to 50%</b>      |
|                                   | Over \$44,000       | <b>Up to 85%</b>      |

These thresholds were set in the 1980s and have never been adjusted for inflation. A couple with \$44,000 in combined income in 1984 was considered comfortable. Today, that same income barely covers basic living expenses in most of California — yet the threshold is identical. This is why more retirees are caught in this trap every year.

## The Tax Torpedo in Action: A Real-World Example

Let's look at a hypothetical couple — John and Mary — retired in Orange County with income coming from all three buckets.

### JOHN & MARY — MARRIED FILING JOINTLY

| Income Source                  | Bucket                  | Annual Amount |
|--------------------------------|-------------------------|---------------|
| Dividend income from brokerage | Bucket 1 — Taxable      | \$4,000       |
| Traditional IRA distributions  | Bucket 2 — Tax-Deferred | \$30,000      |
| Pension from former employer   | Bucket 3 — Guaranteed   | \$12,000      |
| Social Security (combined)     | —                       | \$36,000      |

|  |                 |
|--|-----------------|
| Bucket 1 — Dividends                         | \$4,000         |
| Bucket 2 — IRA Distributions                 | \$30,000        |
| Bucket 3 — Pension                           | \$12,000        |
| 50% of Social Security ( $\$36,000 \div 2$ ) | \$18,000        |
| <b>Provisional Income</b>                    | <b>\$64,000</b> |

Because their Provisional Income (\$64,000) is well above the \$44,000 married threshold, **up to 85% of their \$36,000 Social Security benefit — or \$30,600 — is now subject to federal income tax.**

At a 22% federal tax rate, that's an additional \$6,732 per year in taxes they may not have anticipated.

#### THE TAX TORPEDO EFFECT

# \$1,850

in taxable income created by a single \$1,000 IRA withdrawal

When John and Mary withdraw an extra \$1,000 from their IRA, that withdrawal adds \$1,000 directly to their taxable income — and because it increases their Provisional Income, it simultaneously causes an additional \$850 of their Social Security to become taxable. One dollar in triggers \$1.85 in taxable income. Retirees caught in this zone can face effective marginal tax rates of 40% or higher, even if they're in the 22% bracket.

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STRATEGIES TO PROTECT YOUR BENEFITS

## Who Is Most at Risk?

The Provisional Income trap is not a problem for people who are poor. It's a problem for people who did everything right.

If you saved diligently in a 401(k) or IRA for 30 years, you likely have a large tax-deferred balance. When RMDs kick in at age 73, you may be forced to take distributions whether you need the money or not — and every dollar of those RMDs flows directly into Bucket 2, pushing your Provisional Income higher and triggering more Social Security taxation.

The retirees most at risk are those with two or more of the following:

| Risk Factor  | Why It Matters   |
|--|--|
| Large traditional IRA or 401(k) balance                    | <b>RMDs at age 73 force Bucket 2 income whether you need it or not</b>           |
| Pension from a former employer or government job           | <b>Fixed, fully taxable — flows into Bucket 3 every year with no flexibility</b> |
| Rental properties or investment accounts generating income | <b>1099 income from Bucket 1 adds up quietly each year</b>                       |
| Social Security benefits of \$20,000+ per year             | <b>The 50% SS addition to the formula accelerates the threshold crossing</b>     |
| Municipal bond holdings                                    | <b>The "tax-free" interest still counts in the formula — a common surprise</b>   |

## Three Strategies to Escape the Trap

The key to protecting your Social Security is controlling your Provisional Income before it controls you. Here are the three most effective strategies:

### STRATEGY 01

#### Strategic Roth Integration Before RMDs Begin

Qualified distributions from a Roth IRA do **not** count toward your AGI and do **not** increase your Provisional Income. Converting traditional IRA funds to a Roth IRA during your early retirement years — before Social Security begins or before RMDs kick in — can dramatically reduce your future Bucket 2 income. This strategy requires careful planning because the conversion itself is taxable in the year it occurs. The goal is to pay a modest tax today to avoid a much larger, ongoing tax burden in the future.

#### STRATEGY 02

### **Income Sequencing and Account Coordination**

Not all income sources are treated equally under the Provisional Income formula. Roth distributions, return of principal from non-qualified accounts, and certain life insurance strategies can provide cash flow without increasing Provisional Income. A coordinated income plan maps out exactly which accounts to draw from, in what order, and in what amounts — to keep your Provisional Income below the critical thresholds each year. This is the most powerful lever available to retirees who plan ahead.

#### STRATEGY 03

### **Restructuring the Taxable Bucket**

If your taxable brokerage account is generating significant 1099 income — dividends, interest, capital gains — it may be worth evaluating whether that income is necessary or whether the portfolio can be restructured to reduce ongoing income generation. If you hold municipal bonds for the "tax-free" interest, remember that this interest still counts in the Provisional Income formula. In some cases, a different investment vehicle may produce better after-tax results.

TAKE THE NEXT STEP

# Are You Paying Too Much in Retirement Taxes?

Social Security is the foundation of your retirement income — protected, inflation-adjusted, and guaranteed for life. Losing 50% to 85% of it to unnecessary taxation is one of the most preventable and costly mistakes a retiree can make.

You may be at risk if you have:

- ✓ A traditional IRA or 401(k) with significant balances approaching RMD age
- ✓ A pension from a former employer or government job
- ✓ Rental properties or investment accounts generating 1099 income
- ✓ Social Security benefits of \$20,000 or more per year
- ✓ Municipal bond holdings in a taxable account

**Schedule Your Free Strategy Session**

[calendly.com/greystonewealth/strategy-session](https://calendly.com/greystonewealth/strategy-session)

During this complimentary session, JP will:

- ✓ Calculate your current Provisional Income across all three buckets
- ✓ Identify whether you are at risk of the Tax Torpedo effect

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Greystone Wealth Management is an independent, fiduciary RIA focused on retirement income planning, tax strategies, investment management, Social Security optimization, and estate planning coordination. Located in Huntington Beach, CA 92647 · [greystonewm.com](http://greystonewm.com)

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