The Social Security and Early Withdrawals Guide

> Getting money out of retirement accounts, and Social Security, without overpaying tax takes planning. Here are the rules that decide the bill.

Building a nest egg is only half the job. Getting it out, and receiving Social Security, without handing too much back in tax is its own skill. Three rules do most of the work, and understanding them can save a retiree tens of thousands of dollars.

How Social Security gets taxed

Many retirees are surprised their benefit can be taxed. Whether it is depends on provisional income, which is your other income plus half your benefit. Below 25,000 dollars single or 32,000 joint, none is taxed. Above 34,000 or 44,000, up to 85 percent is.

With a 30,000 dollar benefit and 40,000 dollars of other income, provisional income is 55,000, so about 22,350 dollars of the benefit, roughly 74.5 percent, becomes taxable and is added to your income. Because it hinges on your other income, the timing of withdrawals matters. Roth withdrawals do not count toward provisional income, so drawing from a Roth can lower how much of your benefit is taxed.

The Roth conversion ladder

Low-income years, especially early retirement before Social Security starts, are the cheapest time to move money from a traditional account to a Roth. A conversion ladder does this steadily, converting a set amount each year and paying tax at a low rate, and after five years each converted amount is accessible penalty-free.

The art is sizing each conversion to fill up your current bracket without spilling into the next. Converting 30,000 dollars on top of 50,000 of income keeps you in the 22 percent band and costs about 6,560 dollars that year. Over five years you convert 150,000 dollars at a controlled rate, building a tax-free pool and shrinking future required distributions.

Tapping accounts before 59.5

Early retirees who need income before 59.5 can use rule 72(t) to take substantially equal periodic payments without the 10 percent penalty. The amortization method spreads your balance over your life expectancy at a set rate. A 500,000 dollar balance can throw off about 30,156 dollars a year this way.

The rules are strict and unforgiving. Once you start, you cannot change the amount or stop until five years pass or you reach 59.5, whichever is longer, and a single mistake retroactively applies the penalty plus interest to every payment. Many people set up a separate IRA sized to produce exactly the payment they need, leaving the rest flexible.

Inherited accounts and the 10-year rule

Inheriting an IRA now comes with a clock. Most non-spouse beneficiaries must empty a traditional inherited IRA within 10 years, and every dollar is taxable income when withdrawn. Waiting to take it all in year 10 can pile a huge amount of income into one year at top rates.

Spreading the withdrawals evenly usually keeps more of it in lower brackets. A 500,000 dollar inherited balance growing at 6 percent supports a level withdrawal of about 67,934 dollars a year, emptying it by year 10. The best pace depends on your other income across the decade, taking more in low-income years and less in high ones.

Key takeaway. The timing of withdrawals decides the tax. Use low-income years to convert to Roth, keep provisional income in check to protect your Social Security, and spread inherited-IRA withdrawals to avoid a spike.

Assumptions

- Social Security taxation uses the statutory provisional-income thresholds. Conversion tax uses the current federal brackets.
- These are federal rules. State treatment of Social Security and retirement income varies, and 72(t) schedules are rigid once started.

Sources

- IRS, Social Security and equivalent railroad retirement benefits (Pub. 915)
- IRS, retirement topics, exceptions to tax on early distributions