Roth Distributions and Tax Avoidance on Social Security Benefits and Medicare Premiums

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ABSTRACT

Many investors utilize Roth retirement accounts and Roth conversions in their financial planning due to the commonly referenced benefit of tax-free distributions. In this article, potentially valuable advantages of Roth distributions, including avoiding taxes on Social Security benefits and avoiding additional Medicare Part B and Part D premiums, are explored. How Congress could limit these advantages in the future, without violating the promise of no direct taxes on Roth distributions, is then examined. Both the current state of Roth advantages and potential future changes will be of interest to financial service professionals and their clients.

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Millions of taxpayers make contributions to Roth retirement vehicles such as the Roth IRA, 401(k), 403(b), and 457(b) plans, choosing to prioritize the benefits of future tax-free withdrawals over current tax deductions. In addition, each year numerous taxpayers incur additional tax to convert a traditional pretax retirement plan into a Roth IRA. Taxpayers are willing to forgo the tax deduction available on pretax retirement plans or pay additional tax in the year of a Roth conversion because distributions during retirement are free from ordinary income tax. In addition, the tax-free distribution from a Roth retirement account can be advantageous in estate planning because heirs who inherit a Roth retirement account will not be burdened with taxable distributions, even under the more stringent withdrawal requirements mandated by the Setting Every Community Up for Retirement Enhancement Act (SECURE Act), which became effective at the start of 2020.

While tax-free distributions from Roth retirement accounts during retirement are the primary benefit of a Roth account and are widely known to the public, there are other significant advantages related to Roth distributions, especially for retirement planning around Social Security (SS) benefits and Medicare. Previous articles have explained how tax-free Roth distributions can avoid or reduce income taxes on SS benefits and how Roth distributions escape inclusion in modified adjusted gross income (MAGI) that is used to determine increases in Medicare premiums.[1] This article will provide a basic explanation of these additional tax advantages related to Roth accounts. In addition, the potential concerns about the sustainability of those benefits are discussed, drawing on the precedent of congressional changes to income inclusions and exclusions.

Roth Distributions during Retirement

Taxpayers can accumulate money in a Roth retirement account during working years, convert pretax retirement plans into Roth accounts, or both. Holders of Roth accounts can then take tax-free distributions at retirement. Another advantage of the Roth IRAs is that they are not generally subject to required minimum distributions (RMDs). Also, under the newly enacted SECURE Act 2.0, Roth 401(k), 403(b), 457(b), and other employer-linked Roth plans are no longer subject to RMDs.[2] In addition, employer-linked Roth retirement accounts subject to RMDs can be converted to Roth IRAs. Thus, Roth distributions are generally not included in ordinary income on Form 1040 and are thus considered "tax exempt."

The benefits associated with Roth distributions do not end with avoidance of ordinary income tax. The tax-free nature of Roth distributions also avoids impacting the taxation of SS benefits. A basic example is provided in Table 1. For the 2023 tax year, comparison is given of two different retired, single, taxpayers with no earned income, each filing an individual tax return. It is assumed that each taxpayer withdraws a $115,000 distribution from their retirement accounts, except one taxpayer has a traditional, pretax retirement account and the other taxpayer has a Roth account, as shown in each column in Table 1. Each taxpayer is presumed to take the allowed $15,700 standard deduction for a taxpayer over 65 for the 2023 tax year, $13,850 standard deduction plus $1,850 for age 65 or older.[3] The pretax retiree is required to report the $115,000 distribution on

TABLE 1
Social Security Benefit Tax

(Assuming 2023 tax year for two retired, single taxpayers, each age 70, with no earned income)

	Pretax Retirement Account	Roth Account
Distribution from retirement account	$115,000	$115,000
SS benefits received	$48,000	$48,000
Combined income to determine if SS benefits are taxed: $115,000 + (50% of $48,000)	$139,000	$24,000
SS benefits subject to tax: 50% of benefits if ≥ $25,000; **85% of benefits if > $34,000**	$40,800	$0
AGI: $115,000 + ($48,000 x 85%)	$155,800	$0
MAGI for Medicare income-related monthly adjustment amount (IRMAA)	$155,800	$0
Standard deduction; $13,850 plus $1,850 for age 65 or older	$15,700	$15,700
Income tax on retirement plan distribution and SS benefits		
(rounded to nearest whole dollar)		
Taxable income ($115,000 + $40,800 - $15,700)	$140,100	$0
Total income tax (calculation not included, but available upon request)	$27,024	$0
Tax on distribution from retirement account per tax rate tables	$17,232	$0
Tax on SS benefits received at assumed 24% marginal tax rate ($40,800 x 24%)	**$9,792**	**$0**

Form 1040 as taxable income, while the Roth retiree can exclude the $115,000 distribution from taxable income. As shown in Table 1, this results in a tax burden of $17,232 for the pretax retiree and zero tax for the Roth retiree equal to a tax savings of the same amount, $17,232. The tax-free treatment of the Roth distribution through exclusion from ordinary income is the primary benefit that is usually discussed in regard to Roth IRAs. The specific tax calculations per the 2023 tax rate table are omitted due to brevity but are available upon request.

Continuing the illustration in Table 1, it is assumed that both taxpayers receive $48,000 of SS benefits in 2023. Until 1984, SS benefits were not taxable. Since that time, a portion of SS benefits may be subject to taxation, the amount of which is currently determined by a formula referred to as "combined income," which consists of AGI (not including any potentially taxable SS benefits) plus tax-exempt income (e.g., municipal bond interest income) plus 50 percent of SS benefit received. If combined income exceeds $25,000 for an individual ($32,000 if married), up to 50 percent of SS benefits are taxable and for combined income in excess of $34,000 for an individual ($44,000 if married), then as much as 85 percent of a taxpayer's SS benefits may be taxable, per IRS Publication 915.[4]

In the illustration above, the pretax account retiree's AGI is equal to $115,000, which is income before the standard deduction is considered. There is no tax-exempt income in the example, such as municipal bond interest, to be added into the formula. Fifty percent of the $48,000 SS benefit equals $24,000. So, the combined income for the pretax retiree is $139,000 ($115,000 + $24,000), which is far in excess of the $34,000 income threshold for a single taxpayer that determines if SS benefits are taxable. The result is 85 percent of the $48,000 of SS benefit, $40,800 in this example, being subject to ordinary income tax.

The $40,800 of SS benefits is presumed added to the taxable income from the pretax retirement account distribution, which at the 24 percent marginal tax rate is equal to $9,792 additional tax for the pretax retiree related to SS benefit. In contrast, the Roth account retiree does not have to include their $115,000 distribution in taxable income, nor is it included in combined income that determines the amount of SS benefits subject to tax. For the Roth account retiree, one half of the $48,000 gross SS benefit is equal to $24,000, which does not exceed the $25,000 threshold to determine if 50 percent of SS benefits are taxable. So, the Roth account retiree escapes the $9,792 tax on SS benefits incurred by the retiree with the pretax retirement account!

The tax savings on SS benefits under a Roth can be appreciated even more when looked at over an assumed 20-year retirement period for both taxpayers. In Table 1, if the same amounts are assumed for each year, the pretax retiree ends up paying an additional $195,840 in taxes on SS benefits during a 20-year retirement while the Roth retiree avoids paying the same amount. This is obviously a significant difference in tax burden both on an annual basis *and* especially over the course of the taxpayers' presumed 20-year retirement. Admittedly, during the course of a 20-year retirement, the amount of distribution from either a pretax or Roth retirement account and the amount of SS benefits received would likely vary over time. However, the important takeaway is the significant *cumulative* tax savings on SS benefits from Roth distributions during retirement.

Roth Tax Savings for Medicare Premiums

An additional tax benefit of distributions from Roth accounts compared to pretax accounts is that Roth distributions do not cause an increase in Medicare premiums. For certain beneficiaries, Medicare imposes an additional premium or surcharge, referred to as the income-related monthly adjustment amount (IRMAA), which may be deducted from SS payments (assuming a beneficiary has claimed SS) or as direct bill (if not).

As described in Table 2, the Social Security Administration determines the amount of Medicare Part B (medical insurance) and Part D (prescription drug) premiums for different levels of a taxpayer's MAGI.[5] For Medicare premium purposes, MAGI is calculated slightly differently from the combined income used for SS benefits taxation calculations. MAGI is the adjusted gross income plus tax-exempt income (thus, it relies on the taxable portion of SS benefits having already been calculated). Note that the premiums are by ranges of income and that a "cliff" can occur where a MAGI that is $1.00 over a threshold in Table 2 incurs the same premium as a MAGI at $1.00 below the next threshold.

Complicating matters is that the amount of the Medicare IRMAA premium is based on MAGI from

TABLE 2
Monthly Medicare Premiums for 2023[a]

(The following applies to single + filed an individual tax return, or married + filed a joint tax return)

MAGI	Medicare Part B Monthly Premium Amount	Medicare Part D Prescription Drug Coverage Monthly Premium Amount
Individuals with a MAGI of less than or equal to $97,000 Married couples with a MAGI of $194,000 or less	2023 standard premium = $164.90	Plan premium
Individuals with a MAGI above $97,000 up to $123,000 Married couples with a MAGI above $194,000 up to $246,000	Standard premium + $65.90	Plan premium + $12.20
Individuals with a MAGI above $123,000 up to $153,000 Married couples with a MAGI above $246,000 up to $306,000	Standard premium + $164.80	Plan premium + $31.50
Individuals with a MAGI above $153,000 up to $183,000[b] Married couples with a MAGI above $306,000 up to $366,000	**Standard premium + $263.70**	**Plan premium + $50.70**
Individuals with a MAGI above $183,000 and less than $500,000 Married couples with a MAGI above $366,000 and less than $750,000	Standard premium + $362.60	Plan premium + $70.00
Individuals with a MAGI equal to or above $500,000 Married couples with a MAGI equal to or above $750,000	Standard premium + $395.60	Plan premium + $76.40

[a]The standard full Part B coverage premium for 2023 is $164.90; https://www.ssa.gov/benefits/medicare/medicare-premiums.html.
[b]The MAGI range applicable to the $155,800 "modified AGI for IRMAA" introduced in Table 1.

2 years earlier. Thus, the calculation of MAGI for 2023 will actually impact any IRMAA adjustments for beneficiaries in 2025. For simplicity, we continue to use 2023 IRMAA numbers to calculate the potential premium, as 2025 Medicare premiums are not yet published as of this writing. The use of the latest available Medicare premiums still leads to the same conclusion that compared to distributions from pretax retirement accounts, distributions from Roth accounts avoid additional Medicare premiums resulting in significant tax savings.

Since the pretax retiree has MAGI for Medicare purposes of $155,800 per Table 1, the Medicare Part B monthly premium per Table 2 is $428.60 (standard premium of $164.90 + additional premium of $263.70). Table 2 also shows that since the Roth retiree does not report any ordinary income and their SS benefits are not included in taxable income, their MAGI

TABLE 3
Comparison of Additional Medicare Part B (Medical Insurance) Premium Paid by Retirees[a]

Income-Related Monthly Adjustment Amount

	Additional Monthly Premium	Over 12 Months
Retiree with pretax retirement plan distributions: Yearly income above $153,000 up to $183,000 ($155,800 per Table 1)	$428.60	$5,143.20
Retiree with Roth retirement plan distributions: Yearly income of $97,000 or less basic premium ($0 per Table 1)	$164.90	$1,978.80
Part B premiums avoided for Roth distributions	**$263.70**	**$3,164.40**

[a]Using 2023 Medicare premiums for comparison purposes only.

TABLE 4
Comparison of Additional Medicare Part D (Drug Coverage) Premium Paid by Retirees[a]

Income-Related Monthly Adjustment Amount [b]

	Additional Monthly Premium	Over 12 Months
Retiree with pretax retirement plan distributions: Yearly income above $153,000 up to $183,000 ($155,800 per Table 1)	$50.70	$608.40
Retiree with Roth retirement plan distributions: Yearly income of $97,000 or less basic premium ($0 per Table 1)	$0.00	$0.00
Part D premiums avoided for Roth distributions	**$50.70**	**$608.40**

[a]2023 Medicare premiums used in table.
[b]IRMAA is calculated using the income reported on the tax return from 2 years prior. The 2023 amounts will be used in 2025 to determine additional Medicare B premium. The 2023 IRMAA amounts are used to provide comparisons.

for Medicare premium purposes is zero. Accordingly, the monthly Medicare Part B premium for the Roth retiree is just the standard premium of $164.90 (individuals with a MAGI of less than or equal to $97,000). Thus, Table 3 shows the Roth retiree avoids $263.70 of additional Medicare Part B premium each month compared to the pretax retiree, which equates to a savings over 12 months of $3,164.40.

Medicare Part D premiums are also affected by MAGI, again favoring the Roth account retiree. Each retiree will have selected a prescription drug coverage plan when they enrolled in Medicare Part D. Depending upon the taxpayer's MAGI, an additional Part D premium may be owed, as indicated in Table 2.

Based on the same MAGI amounts for each retiree discussed above, the last column in Table 2 indicates that since the pretax retiree's MAGI ($155,800) exceeds the $153,000 threshold, an additional monthly premium of $50.70 will be owed. Table 4 shows that this amounts to $608.40 of additional premium over 12 months. In contrast, the Roth retiree will not owe any additional Part D premium, just the plan premium selected when enrolling in Part D.

Overall, the tax savings from Roth distributions on SS benefits and on Medicare Part B and Part D premiums are significant on an annual basis and even more so when considered over the totality of a taxpayer's retirement years. The ordinary income tax savings on the distributions of Roth accounts is what is mentioned most when discussing the benefits of Roth retirement vehicles. Yet, the savings from avoiding additional taxes on SS benefits and Medicare Parts B and D premiums can be almost as advantageous, as seen in Table 5.

Discussed next is whether the tax advantages applicable to Roth distributions will continue to be available.

Are Roth Tax Advantages for Social Security Benefits and Medicare Premiums at Risk?

Roth retirement account distributions are currently free from ordinary income tax. However, a consistent concern among taxpayers about committing retirement funds to a Roth retirement account or converting an existing pretax retirement account to a Roth IRA is the sustainability of the federal government's promise that distributions from Roth accounts will continue to be tax free.

Ironically, one of the few financial experts who is not confident of Roth accounts retaining their tax-free status is the person credited with starting the first 401(k) retirement plan, Ted Benna. He is on record as stating that Congress could sometime in the fu-

TABLE 5
Total Tax Savings for Roth Retirement Account

	Over 12 Months
Tax avoided on SS benefits received	$9,792.00
Additional Medicare premiums avoided:	
Part B	$3,164.40
Part D	$608.40
Total Roth tax savings on SS benefits and Medicare premiums	**$13,564.80**
Tax avoided on distribution from retirement accounts (per Table 1)	$17,232.00
Total tax savings attributable to Roth IRA	$30,796.80

ture begin to tax Roth retirement accounts and their distributions. Benna cites the example of SS benefits, which prior to 1983 were completely tax free.[6] Then, in 1983, up to 50 percent of SS benefits became subject to tax depending upon the taxpayer's income level. In 1993, up to 85 percent of SS benefits became subject to tax, the current law today, which was analyzed earlier in this article. Benna also points out that SS taxes paid by employees are paid with employees' after-tax money, similar to after-tax Roth contributions. So, SS bears a similarity to Roth retirement vehicles except Roth distributions are currently tax free and SS benefits can be taxed.

In addition, recent news stories describe examples of taxpayers that have accumulated massive Roth balances and presumably could withdraw millions and even billions of dollars from their Roth accounts tax free.[7] News stories about massive Roth IRAs balances lead some in Congress to call for limits on the accumulations in Roth accounts or require large balances to be exposed to taxation.[8]

Despite the misgivings about Roth accounts by the founder of the first 401(k) plan, and some proposals in Congress in response to massive Roth accounts, most financial advisors express confidence that Congress will not renege on the fundamental promise that distributions from Roth accounts will continue to be free from ordinary income tax.[9]

Stealth Taxes on Roth Distributions?

Even though the tax-free status of Roth distributions may appear safe, speculation has been raised about a possible "stealth tax" on Roth retirement accounts where distributions not directly taxed as ordinary income could be added into calculations that determine tax on SS benefits and increased Medicare premiums, which was illustrated earlier. Well-known retirement account expert and author, Ed Slott, a strong proponent of Roth accounts, has suggested this possibility:

> It's possible (lawmakers) could trim around the edges by using Roth distributions to increase stealth type taxes. For example, including the value of tax-free Roth distributions in income to tax other items, like they did with SS years ago, and for increasing Medicare surcharges or limiting other types of tax deductions or benefits based on income.[10]

An article in the financial press speculated on the impact on Roth IRAs of news stories about multimillion- and billion-dollar Roth IRA accounts. Among the potential reactions could be an effort by Congress to impose a stealth tax on Roth IRA withdrawals:

> Congress also might impose required minimum distributions on Roth IRAs or include Roth IRA distributions in modified adjusted gross income when calculating taxes on SS benefits, the Medicare premium surtax, and other Stealth Taxes.[11]

With the stroke of a pen, Congress could add Roth distributions to the calculation of combined income for determining tax on SS benefits and include Roth distributions in MAGI, thus increasing premiums on Medicare Part B and Part D. The recent elimination of the stretch IRA by the SECURE Act, effective in 2020, is an example of Congress reversing a long-standing retirement account tax advantage that taxpayers assumed would always be available and raises the question as to what other retirement breaks could be reduced or eliminated.[12]

Should Roth Distributions Impact SS Benefits Tax and Medicare Premiums?

Do existing tax laws provide a precedent for imposing a stealth tax on Roth distributions? Does adherence to sound tax policy and public policy provide a pathway for Congress to justify imposing a stealth tax upon Roth distribution? One current example of how tax-free distributions from an asset do impose stealth taxes on SS benefits and increase Medicare premiums is the tax treatment of tax-exempt interest income payments received from municipal bonds. Qualifying municipal bond coupon payments, i.e., those not derived from municipal bonds issued for taxable activities, are generally exempt from being taxed as "ordinary income" (Internal Revenue Code Sec. 103). However, municipal bond interest is included in the determination of tax on SS benefits and is included in MAGI used to determine additional premiums for Medicare Part B and Part D, discussed earlier. Both investments in municipal bonds and contributions to Roth IRAs are made with after-tax dollars and both distributions are exempt from inclusion in ordinary income and are thus not "directly" taxed as ordinary income. Despite their similarity, municipal-bond interest can increase the tax on SS benefits and increase Medicare premiums. Roth distributions currently do not.

Aside from the analogy to municipal-bond interest, what arguments could be made in support of including Roth distributions in the determination of taxes on SS benefits and additional Medicare premiums?

In regard to SS benefits, both holders of pretax retirement accounts and Roth retirement accounts were subject to the same employee SS taxes during years of employment. Both are subject to the same calculations as to the amount of SS benefits received during retirement. Since taxpayers who hold Roth accounts are not subject to greater SS tax during employment or entitled to less SS benefits during retirement, is it consistent tax policy for recipients of Roth distributions to avoid income taxes on SS benefits that pretax retirement account taxpayers are subject to?

A similar question is raised regarding additional premiums for Medicare Part B and Part D. In the absence of evidence that the availability and consumption of health care resources covered by Medicare Parts B and D are less for Roth accounts holders than pretax retirement account holders, what tax or health care policy justification are there for recipients of Roth distributions to avoid the additional Medicare premiums paid by taxpayers receiving distributions from pretax retirement accounts?

Congress established Roth's tax-exempt distribution as an incentive for taxpayers to contribute towards their retirement. There was a clear intent that Roth distributions would be exempt from ordinary income tax. However, was it the intent of Congress when the Roth was established to create a class of taxpayers who would be exempt from tax on SS benefits and sheltered from additional Medicare premiums that other U.S. taxpayers are subject to? Are Roth tax advantages related to SS benefits and Medicare an unintended consequence of the original tax law that created Roth accounts? It would appear so.

Thus, the current situation creates a mismatch between benefits and costs. This violates the general expectation that tax systems treat similar taxpayers in a similar fashion. In income taxes, assuming consistent rates and investment options, taxpayers contributing to a pretax account receive current benefits (tax deductions) and future costs (tax on withdrawal), while the contributions to a Roth do not provide current benefits (no tax deduction), but do not entail future costs (no tax on withdrawal). By contrast, from a SS and Medicare tax perspective, contributors to both pretax and Roth retirement accounts entail current costs (contributions are similarly subject to SS or Medicare taxes), but different future impacts (SS and Medicare benefits incur negative impacts for holders of pretax accounts, but not for Roth accounts). This creates an inconsistency in the costs and benefits of comparable programs.[13] It is doubtful that these contradictions in the tax law related to retirement accounts have gone unnoticed by tax writers in the federal government.

What may have contributed to the incongruence of the tax treatments of distributions of pretax retirement accounts and Roth retirement accounts is the timeline of the development of tax laws relative to the establishment of Roth retirement vehicles. The imposition of a tax on SS benefits occurred in two stages in 1983 and 1993, respectively, and preceded the establishment of Roth IRAs in 1997. So, Roth distributions did not exist when the tax laws for SS benefits were established. Though the IRMAA provisions affecting Medicare premiums were established in 2003 (after Roth IRAs were first allowed), Roth IRAs were relatively new and the balances were much smaller than today and distributions were relatively insignificant. The Roth 401(k) plans, sponsored by an employer, were created in 2006, 3 years after IRMAA was established, and 23 years and 13 years, respectively, after the 1983 and 1993 tax on SS benefits were enacted.

So, Roth IRAs and Roth 401(k) plans did not exist in 1983 and 1993 (thus predating SS benefit taxability policy design). Roth 401(k) plans did not yet exist in 2003 (thus predating IRMAA policy design) and Roth IRAs were relatively insignificant in 2003. In the run-up to tax legislation in 1983, 1993, and 2003, tax writers likely did not foresee the creation of Roth accounts or anticipate that distributions from Roth accounts would become significant in the years later. Thus, the tax incongruence between pretax and Roth distributions may be as much due to the timing of the creation of Roth IRAs and 401(k) plans relative to when the tax laws on SS benefits and IRMAA were enacted. As such, one could see how including Roth distributions in the determination of tax on SS benefits and for IRMAA could be defended or described as a "technical adjustment" or "correction" to the tax laws.

Summary

Roth distributions currently provide significant tax advantages related to SS benefits and Medicare premiums. However, the federal government funding needs and controversy about the use of Roth accounts by high-wealth individuals could potentially generate enough political motivation to reduce some of the advantages associated with Roth accounts. While directly taxing Roth distributions as ordinary income appears unlikely, stealth taxes seem plausible. A stealth tax would provide desperately needed tax revenue to address looming SS and Medicare funding shortfalls without raising income tax rates or including Roth distributions in ordinary income, thus keeping the political promise that Roth distributions would be free from ordinary income tax.

Aside from the additional tax revenue from a stealth tax, including Roth distributions in the calculations for SS benefit taxation and Medicare Part B and Part D additional premiums are aligned with consistent tax treatment for recipients of the same government benefits and programs. It would also have the ancillary effect of creating greater consistency with the treatment between one source of tax-exempt income, municipal bonds interest, and another source, tax-exempt distributions from Roth retirement accounts.

Taxpayers with pretax retirement accounts are frequently encouraged by financial advisors to incur a significant current tax burden to convert a large portion of their pretax accounts to Roth accounts, partially on the assumption that large cumulative future tax savings on SS benefits and Medicare premiums will continue to be available far into the future. However, the repeal of the stretch IRA serves as a precedent for the elimination of a long-standing retirement account tax benefit that some taxpayers planned on always being available. Given the demands for additional tax revenue by the federal government and the arguments available in support of imposing a stealth tax on Roth distributions, the Roth tax advantages related to SS benefits and Medicare premiums that some taxpayers are relying on might not be sustainable in the future. ■

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