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Social Security: Calculation and History of Taxing Benefits

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Summary

Social Security provides monthly benefits to qualified retirees, disabled workers, and their spouses and dependents. Until 1984, Social Security benefits were exempt from the federal income tax. In 1983, Congress approved recommendations from the National Commission on Social Security Reform (also known as the Greenspan Commission) to tax Social Security benefits above a specified income threshold. Specifically, beginning in 1984, up to 50% of Social Security and Railroad Retirement Board (RRB) Tier 1 benefits are taxable for individuals whose provisional income exceeds $25,000. The threshold is $32,000 for married couples. Provisional income is defined as the total income from all sources recognized for tax purposes plus certain otherwise tax-exempt income, including half of Social Security and RRB Tier 1 benefits. The proceeds from taxing Social Security and Railroad Retirement Tier I benefits at the 50% rate are credited to the Old-Age and Survivors Insurance (OASI) trust fund, the Disability Insurance (DI) trust fund, and the Railroad Retirement system respectively, based on the source of the benefit taxed.

In 1993, Congress passed a second income threshold for the calculation of taxable Social Security and RRB Tier I benefits. This second threshold (often referred to as Tier 2) taxes up to 85% of benefits for individuals whose provisional income exceeds $34,000 and for married couples whose provisional income exceeds $44,000. The tax proceeds from the second tier goes to the Medicare Hospital Insurance (HI) Trust Fund.

Income from taxation of benefits to the Social Security trust funds totaled $16.9 billion in 2008, or 2.1% of its total income. For Medicare, income from taxation of benefits totaled $11.7 billion in 2008, or 5.1% of total HI trust fund income. Because the income thresholds to determine the taxation of Social Security benefits are not indexed for inflation or wage growth, the share of beneficiaries affected by these thresholds is expected to increase over time. According to the Congressional Budget Office (CBO), 39% of (or 16.9 million) Social Security beneficiaries were affected by the income taxation of Social Security benefits in 2005.

In the 111th Congress, legislation has been introduced that would impact the taxation of Social Security benefits by indexing the income thresholds, repealing the taxation of benefits at the 85% level, and repealing all taxation of Social Security benefits. This report will be updated as warranted by legislative activity.

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The Social Security system provides monthly benefits to qualified retirees, disabled workers, and their spouses and dependents. Until 1984, Social Security benefits were exempt from the federal income tax. Then in 1984, Congress enacted legislation to begin to tax Social Security benefits with a formula for determining taxable benefits that gradually increased as a person's income rose above a specified income threshold. In 1993, a second income threshold was added that increased the share of benefits that are taxable. These two thresholds are often referred to as Tier 1 and Tier 2.

Calculation of Taxable Social Security Benefits

In general, the Social Security and Tier I Railroad Retirement[1] benefits of most recipients are not subject to the income tax. However, up to 85% of Social Security and Tier I Railroad Retirement benefits can be included in taxable income for recipients whose "provisional income" exceeds either of two statutory thresholds (based on filing status).[2]

"Provisional income" is total income,[3] *plus* certain otherwise tax-exempt income (tax-exempt interest), *plus* the addition (or adding back) of certain income specifically excluded from federal income taxation (interest on certain U.S. savings bonds,[4] employer-provided adoption benefits, foreign earned income or foreign housing, and income earned in Puerto Rico or American Samoa by bona fide residents), and *plus* one-half (50%) of Social Security and Tier I Railroad Retirement benefits.

The thresholds below which no Social Security or Tier I benefits are taxable are $25,000 for taxpayers filing as single, head of household, or qualifying widow(er) and $32,000 for taxpayers filing a joint return. A taxpayer who is married filing separately who has lived apart from his or her spouse all tax year has a threshold amount of $25,000. A taxpayer who is married filing separately who lived with his or her spouse at any point during the tax year, has a threshold amount of $0.

If provisional income is between the first tier thresholds of $25,000 (single) or $32,000 (married couple) and the second tier thresholds of $34,000 (single) or $44,000 (married couple), the amount of Social Security and Tier I benefits subject to tax is the lesser of (1) one-half (50%) of Social Security and Tier I benefits; or (2) one-half (50%) of provisional income in excess of the first threshold.

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[1] Tier I railroad retirement benefits are paid to a qualified railroad retiree who has met the quarterly work requirements for Social Security benefit eligibility. The retiree receives Social Security benefits based on the work history that qualified the retiree for Social Security benefits, and Tier I benefits based on both the Social Security and railroad work histories. The actual Social Security benefits received are subtracted from this calculation of Tier I benefits to get actual Tier I benefits.

[2] For additional information on calculating taxable Social Security benefits, see U.S. Department of the Treasury, Internal Revenue Service, "Social Security and Equivalent Railroad Retirement Benefits," *Publication 915*, 2006, available online at http://www.irs.gov/pub/irs-pdf/p915.pdf.

[3] Total income is the total of income from all sources recognized for tax purposes. See *Publication 915* for details on the sources of income included in computing provisional income.

[4] Interest on qualified U.S. savings bonds used to pay certain educational expenses is exempt from federal income taxation.

If income is above the second tier threshold, the amount of Social Security and Tier I Railroad Retirement benefits subject to tax is the lesser of (1) 85% of Social Security and Tier I benefits; or (2) 85% of provisional income above the second threshold, plus the smaller of (a) $4,500 (single) or $6,000 (married couple);[5] or (b) one-half (50%) of Social Security and Tier I benefits.

Because the threshold for a married taxpayer filing separately who has lived with his or her spouse at any time during the tax year is $0, the taxable benefits in such a case are the lesser of 85% of Social Security and Tier I benefits or 85% of provisional income. None of the thresholds are indexed for inflation or wage growth. **Table 1** summarizes the thresholds and calculation of taxable Social Security and Tier I Railroad Retirement benefits.

Table 1. Calculation of Taxable Social Security and Tier I Railroad Retirement Benefits

Provisional Income (*)	Calculation of Taxable Social Security and Tier I Railroad Retirement Benefits
Single Taxpayer	
Less than $25,000	No taxable Social Security or Tier I Railroad Retirement benefits
$25,000 less than $34,000	Lesser of (1) 50% of Social Security and Tier I benefits; or
	(2) 50% of provisional income above $25,000
More than $34,000	Lesser of (1) 85% of Social Security and Tier I benefits; or
	(2) 85% of provisional income above $34,000 *plus* lesser of
	(A) $4,500; or
	(B) 50% of Social Security and Tier I benefits
Married Taxpayer	
Less than $32,000	No taxable Social Security or Tier I Railroad Retirement benefits
$32,000 less than $44,000	Lesser of (1) 50% of Social Security benefits; or
	(2) 50% of provisional income above $32,000
More than $44,000	Lesser of (1) 85% of Social Security benefits; or
	(2) 85% of provisional income above $44,000 *plus* lesser of
	(A) $6,000; or
	(B) 50% of Social Security and Tier I benefits

Source: Table prepared by the Congressional Research Service (CRS).

Note: Provisional income is total income plus certain income exclusions plus one-half (50%) of Social Security benefits.

The following two examples in **Table 2** illustrate how taxable Security benefits may be calculated for a single retiree in tax year 2008. The retiree is at least 62 years of age, and receives $12,948 in annual Social Security benefits—the average in December 2007 for a retiree.[6] The examples include other (non-Social Security) income of $22,000 or $32,000.

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[5] The $4,500 (single) and $6,000 (married couple) amounts are the maximum taxes for the Tier I calculation, and are equivalent to one-half (50%) of the difference between the first and second tier thresholds.

[6] The average monthly OASI payment for a retiree in December 2007 was $1,079. This would be an annual payment (continued...)

Table 2. Example of Calculation of Social Security Benefits for Average Social Security Recipient and Different Assumptions about Other Income

	John	Mary
Step 1: Calculate Provisional Income		
Other income	$22,000	$32,000
+ 50% of Social Security (assume Social Security benefits are $12,948)	$6,474	$6,474
= Provisional income	$28,474	$38,474
Step 2: Compare Provisional Income to 1st Tier Threshold		
First tier threshold	*$25,000*	*$25,000*
Calculate Excess over First Tier Threshold Lesser of		
• Provisional income *minus* first tier threshold *or*		
• Difference between first and second tier thresholds [$9,000]	$3,474	$9,000
First tier taxable benefits Equals Lesser of		
• 50% of Social Security or tier I benefits *or*		
• 50% of excess over first tier	$1,737	$4,500
Step 3: Compare Prov. Income To 2nd Tier Threshold		
Second tier threshold	*$34,000*	*$34,000*
Calculate Excess over second tier		
• Provisional income *minus* second tier threshold	$0	$4,474
Second tier taxable benefits		
85% of excess	$0	$3,803
Step 4: Calculate Total Taxable Social Security Benefits		
If provisional income is less than $34,000, total taxable benefits equal first tier taxable benefits.		
If provisional income is greater than $34,000, total taxable benefits equal the lesser of		
• 85% of Social Security benefits (=$11,006) *or*		
• First tier taxable benefits *plus* second tier taxable benefits	$1,737	$8,303

Source: Table prepared by the Congressional Research Service (CRS).

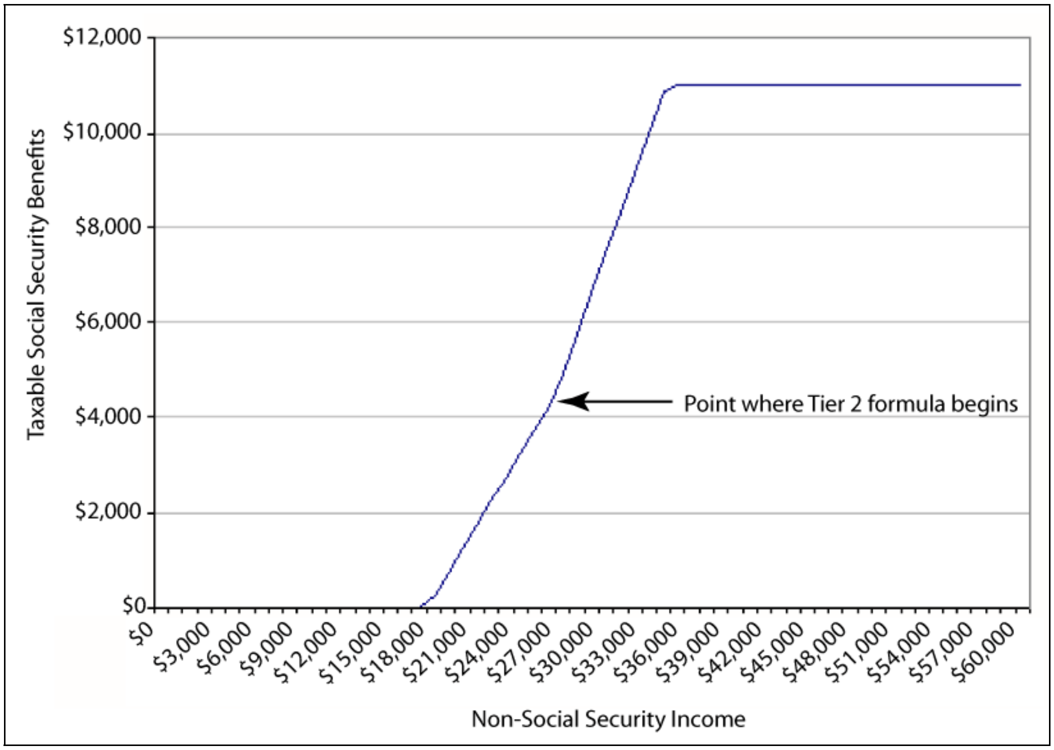
Figure 1 shows taxable Social Security benefits for a single retiree with Social Security benefits of $12,948 as non-Social Security income (and provisional income) increases. Shown on the figure is the point at which taxable benefits are calculated using the Tier 2 formula in which the comparisons in the formula use a ratio of 85% (rather than the 50% ratio for Tier 1). At this point, each additional dollar of non-Social Security income results in a larger increase in taxable Social Security benefits (because of the ratio change from 50% to 85% in the calculations). In **Figure 1**,

(...continued)

amount of $12,948. Information on current monthly benefit payments is available by accessing beneficiary databases at http://www.ssa.gov/OACT/ProgData/icp.html.

the taxable Social Security benefits reach a maximum of 85% of Social Security benefits (illustrated by a flattening of the line) when non-Social Security income equals $34,000 in this example.

Figure 1. Taxable Social Security Benefits as Non-Social Security (and Provisional) Income Increases for a Single Retiree with $12,948 in Annual Social Security Benefits, Tax Year 2008



Source: Figure prepared by the Congressional Research Service (CRS).

The calculation of taxable Social Security benefits depends on the level of benefits, the tax filing status, and non-Social Security income. Holding non-Social Security income constant, as benefits increase, taxable Social Security benefits will increase. For the same levels of non-Social Security income and Social Security benefits, a married couple will have lower taxable Social Security benefits than a single retiree. Consequently, **Figure 1** does not reflect other levels of benefits, or the impact of taxation on a married couple filing a joint tax return.

Special Considerations

There are special considerations in which the application of the taxation of benefits formula may vary. These include lump sum distributions, repayments, coordination of workers compensation, treatment of non-residential aliens, and withholding from wages. Each of these issues is discussed in more detail in the **Appendix** to this report.

State Taxation

Although the Railroad Retirement Act prohibits states from taxing railroad retirement benefits (including any federally taxable Tier I benefits), states may tax Social Security benefits. In general, state personal income taxes follow federal taxes. That is, many states use as a beginning point for the state income tax calculations either federal adjusted gross income, federal taxable income, or federal taxes paid. All of these beginning points include the federally taxed portion of Social Security benefits. States with these beginning points for state taxation must then make an adjustment, or subtraction from income (or taxes), for railroad retirement benefits. A state may also make an adjustment for all or part or the federally taxed Social Security benefits. Some states do not begin the calculation of state income taxes with these federal tax values, but instead begin with a calculation based on income by source. The state may then include part or all of Social Security benefits[7] in the state calculation of income.

In tax year 2008, 28 of the 41 states (and the District of Columbia) with a personal income tax, fully excluded Social Security benefits from the state personal income tax. Fourteen states tax all, or part, of Social Security benefits. Nine states do not have an income tax or have a tax limited to specific kinds of unearned income. **Table 3** identifies what states fall into each of these categories for tax year 2008.

Table 3. State Income Taxation of Social Security Benefits, Tax Year 2008

States taxing all or part of the federal taxable Social Security benefits	Colorado, Connecticut, Iowa,[a] Kansas, Minnesota, Missouri,[a] Montana, Nebraska, New Mexico, North Dakota, Rhode Island, Utah, Vermont, West Virginia
States excluding Social Security benefits from state personal income taxes	Alabama, Arizona, Arkansas, California, Delaware, District of Columbia, Georgia, Hawaii, Idaho, Indiana, Illinois, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Mississippi, New Jersey, New York, North Carolina, Ohio, Oklahoma, Oregon, Pennsylvania, South Carolina, Virginia and Wisconsin
States without a state personal income tax	Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, Wyoming

Source: Minnesota House of Representatives, House Research; available at http://www.house.leg.state.mn.us/hrd/issinfo/sstaxes.htm.

a. Iowa will fully exempt benefits in 2014, and Missouri will fully exempt benefits beginning in tax year 2012.

Impact of Taxing Social Security Benefits

Because the income thresholds to determine the taxation of Social Security benefits are not indexed for inflation or wage growth, the share of beneficiaries affected by these thresholds is increasing over time. According to the Congressional Budget Office (CBO), 39% of (or 16.9 million) Social Security beneficiaries were affected by the income taxation of Social Security benefits in 2005. This compares to 32% of Social Security beneficiaries affected by taxation of benefit in 2000 and 26% in 1998.[8]

[7] States that chose to tax Social Security benefits, generally tax up to the federally taxed amount.

[8] CBO estimates are reported in the Green Book, Committee on Ways and Means, U.S. House of Representatives (continued...)

Table 4 shows the CBO estimates of the number of Social Security beneficiaries, the number of beneficiaries affected by the taxation of Social Security benefits, and the percent of beneficiaries affected by taxation by level of income (cash income for the tax unit plus capital gains realizations). As shown in **Table 4**, the percentage of Social Security beneficiaries affected increases with the income level, with more than 90% of beneficiaries with an income of $40,000 or more affected by the taxation of Social Security benefits.

Table 4. Number and Percentage of Beneficiaries with Taxable Social Security Benefits by Income Class Under 2005

Level of Income	Number of Social Security Beneficiaries (in thousands)	Number of Beneficiaries Affected by Taxation (in thousands)	Percentage of Beneficiaries Affected by Taxation
Less than $10,000	5,957	0	0.0%
$10,000 - $15,000	5,201	4	0.1%
$15,000 - $20,000	3,688	12	0.3%
$20,000 - $25,000	3,347	11	0.3%
$25,000 - $30,000	2,917	76	2.6%
$30,000 - $40,000	5,260	1,478	28.1%
$40,000 - $50,000	4,497	3,168	70.4%
$50,000 - $100,000	8,931	8,578	96.0%
Over $100,000	3,632	3,607	99.3%
Total	43,429	16,934	39.0%

Source: Congressional Budget Office simulations based on data from the Statistics of Income and supplemented by data from the Current Population Survey.

Notes: Income is defined as AGI plus statutory adjustments, tax-exempt interest, and nontaxable Social Security benefits. Number of Social Security beneficiaries includes beneficiaries under and over age 65.

As previously noted, because of the thresholds not all Social Security benefits are taxable. **Figure 2** shows how Social Security benefits impact taxable income for a given level of Social Security benefits ($12, 948) for a single retiree in tax year 2008.[9] As non-Social Security income increases, more of Social Security benefits become taxable. This leads to an increase in overall taxable income. Because the taxation of Social Security benefits is capped at 85% in the second tier, the darkly shaded area in **Figure 2** shows that the amount of Social Security benefits that are taxed remains constant as non-Social Security income increases beyond the second threshold.

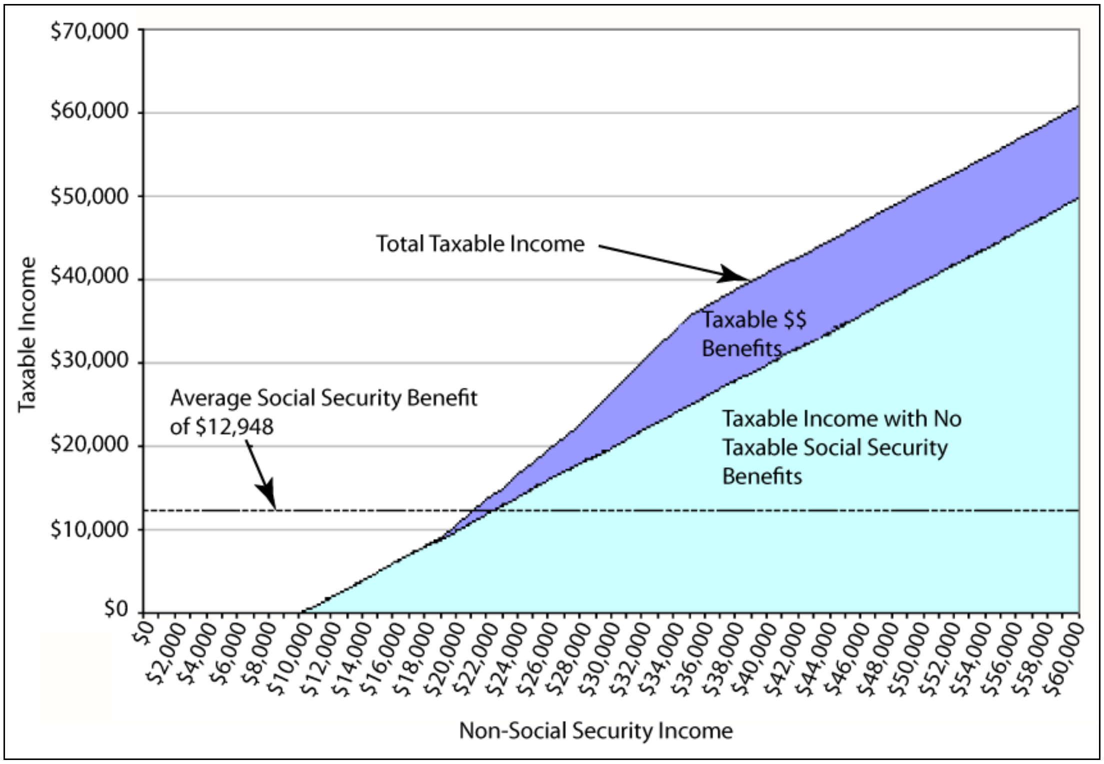
(...continued)

(1998, 2000 and 2008 editions). Changes from year to year may also reflect changes to CBO's methodology and data sources over time.

[9] All tax calculations for this report are estimated by CRS. The taxpayer is assumed to have used the standard deduction, including the additional amount for the elderly and disabled.

Figure 2. Taxable Income for an Average Single Retiree

Tax Year 2008

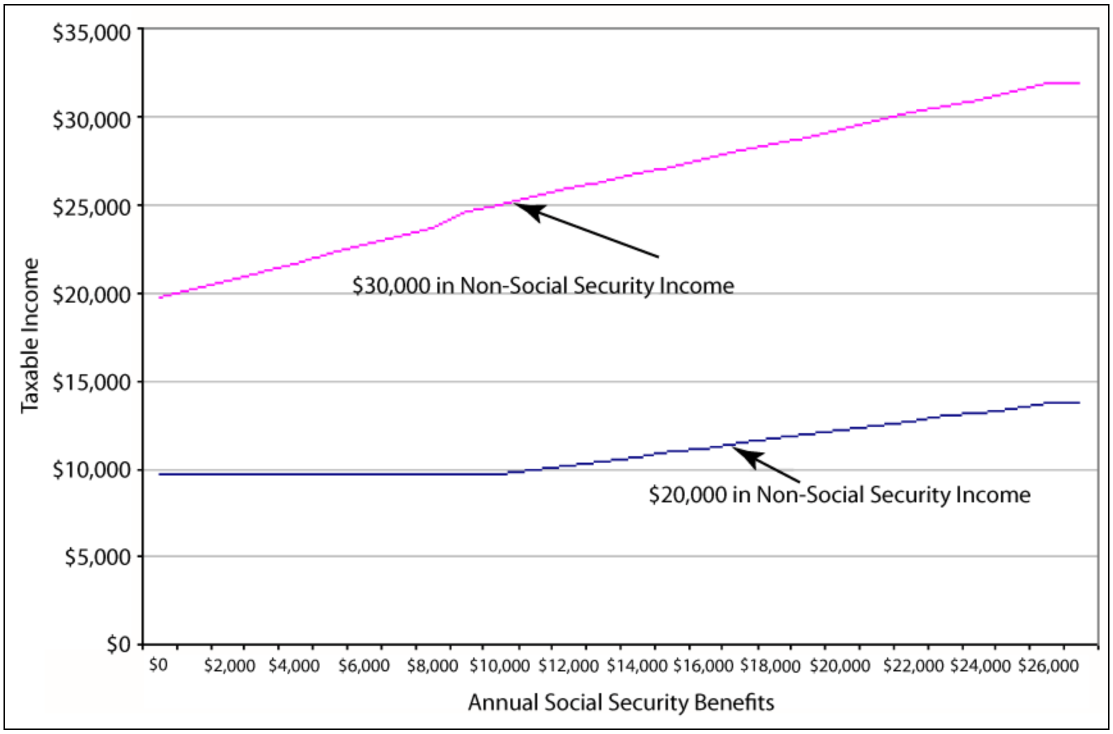


Source: Figure prepared by congressional Research Service (CRS).

Figure 3 shows how different levels of Social Security benefits affect taxable income for a single retiree with either $20,000 or $30,000 in non-Social Security income.[10] In **Figure 3**, the Social Security benefits increase until they reach the annual maximum benefits for a person receiving benefits at full retirement age (65 years and 10 months) in 2008—$26,220.

[10] Ibid.

Figure 3. Taxable Income for a Single Retiree with $20,000 or $30,000 in Non-Social Security Income as Annual Social Security Benefits Increase, Tax Year 2008



Source: Figure prepared by the Congressional Research Service (CRS). Assumes Social Security benefits increase to $26,220—the maximum benefit in 2008 for a person retiring in 2008 at full retirement age (65 years and 10 months of age).

Table 5 shows the impact of rising income on the share of benefits that are taxed for the U.S. taxpayers in 2005. Level of income includes cash income plus capital gains realizations. As shown in **Table 5**, as income increases, taxes as a percent of Social Security benefits rises.

Table 5. Social Security Benefits and Taxes on Social Security Benefits by Income Class Under 2005 Law

Level of Income	Social Security Benefits (in millions)	Taxes on Social Security Benefits (in millions)	Taxes as a Percent of Benefits
Less than $10,000	$40,403	$0	0.0%
$10,000 - $15,000	$53,769	$1	0.0%
$15,000 - $20,000	$40,480	$4	0.0%
$20,000 - $25,000	$36,927	$9	0.0%
$25,000 - $30,000	$33,009	$17	0.1%
$30,000 - $40,000	$59,893	$390	0.7%
$40,000 - $50,000	$51,717	$1,412	2.7%
$50,000 - $100,000	$110,421	$11,508	10.4%
Over $100,000	$49,378	$10,767	21.8%
Total	$475,997	$24,107	5.1%

Source: Congressional Budget Office simulations based on data from the Statistics of Income and supplemented by data from the Current Population Survey.

Notes: Income is defined as AGI plus statutory adjustments, tax-exempt interest, and nontaxable Social Security benefits. Number of Social Security beneficiaries includes beneficiaries under and over age 65.

Impact on the Trust Funds

The proceeds from taxing Social Security and Tier I benefits at the 50% rate are credited to the Old-Age and Survivors Insurance (OASI) trust fund, the Disability Insurance (DI) trust fund and the Railroad Retirement system respectively, on the basis of the source of the benefits taxed. Proceeds from taxing Social Security benefits and Tier I benefits at the 85% rate are credited to the Hospital Insurance trust fund (HI) of Medicare. In 2008, the Trustees Report reported income to OASDI of $16.9 billion from the taxation of benefits, or 2.1% of the combined income for both funds.[11] Income from the taxation of benefits in the HI fund were $11.7 billion, or 5.1% of total HI fund income.[12] Income taxes transferred to support railroad retirement programs were comparatively smaller, $359 million, in 2008.[13]

History of Taxing Social Security Benefits

Until 1984, Social Security benefits were exempt from the federal income tax. The exclusion was based on rulings made in 1938 and 1941 by the Department of the Treasury, Bureau of Internal Revenue (the predecessor of the Internal Revenue Service). The 1941 Bureau ruling on OASDI payments viewed benefits as being for general welfare and reasoned that subjecting the payments to income taxation would be contrary to the purposes of Social Security.[14]

Under these rules, the treatment of Social Security benefits was similar to that of certain types of government transfer payments (such as Aid to Families with Dependent Children, Supplemental Security Income, and black lung benefits). This was in sharp contrast to then-current rules for retirement benefits under private pension plans, the Federal Civil Service Retirement System (CSRS), and other government pension systems. Benefits from these other pension plans were fully taxable, except for the portion of total lifetime benefits (using projected life expectancy) attributable to the employee’s own contributions to the system (and on which he or she had already paid income tax).

Currently (and as in 1941), under Social Security the worker’s contribution to the system is his or her share (one-half (50%)) of the payroll tax, officially known as the Federal Insurance Contributions Act (FICA) tax. The amount the worker pays into the Social Security system in

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[11] Social Security Administration, *2009 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds,* May 12, 2009, available at http://www.ssa.gov/OACT/TR/TR09/tr09.pdf.

[12] Center for Medicare and Medicaid Services, *2009 Annual Report of the Board of Trustees of the Federal Hospital Insurance Trust and Federal Supplementary Medical Insurance Trust Funds*, May 12, 2009, available at http://www.cms.hhs.gov/ReportsTrustFunds/downloads/tr2009.pdf.

[13] Railroad Retirement Board, 2008 Annual Report, available at http://www.rrb.gov/pdf/opa/annualrprt/annualreport.pdf.

[14] U.S. Congress, Senate Committee on Finance, *Tax Free Status of Social Security Benefits, Report to Accompany S.Res. 87*, Comm. Rep. No. 97-135, June 15, 1981.

FICA taxes is not subtracted to determine income subject to the federal income tax, and is therefore taxed. The employer's contributions to the system are not considered part of the employee's gross income, and are deductible from the employer's business income as a business expense. Consequently, neither the employee or the employer pays taxes on the employer's contribution.

The 1979 Advisory Council on Social Security concluded that the 1941 ruling was wrong and that the tax treatment of private pensions was a more appropriate model for tax treatment of Social Security benefits.[15] The council estimated that the most anyone who entered the workforce in 1979 would pay in payroll taxes during his or her lifetime would equal 17% of the Social Security benefits he or she would ultimately receive. (This was the most any individual would pay; in the aggregate, workers would make payroll tax payments amounting to substantially less than 17% of their ultimate benefits.) Because of the administrative difficulties involved in determining the taxable amount of each individual benefit, the council recommended instead that half of everyone's benefit be taxed. They justified this ratio as a matter of "rough justice" and noted that it coincided with the portion of the tax (the employer's share) on which income taxes had not been paid. This position to tax Social Security benefits was in contrast to the position of the National Commission on Social Security, established by Congress in the Social Security Amendments of 1977 (P.L. 95-216). The commission did not, in its 1981 final report, include a recommendation to tax Social Security benefits.

The National Commission on Social Security Reform (often referred to as the "Greenspan Commission"), appointed by President Reagan in 1981, recommended in its 1983 report[16] that, beginning in 1984, one-half (50%) of Social Security cash benefits and Tier I benefits payable under the Railroad Retirement Act be taxable for individuals whose adjusted gross income, excluding Social Security cash benefits, exceeded certain thresholds—$20,000 for a single taxpayer, and $25,000 for a married couple, with the proceeds of such taxation credited to the Social Security trust funds. The commission did not include any provisions for indexing the threshold amounts. The commission estimated that 10% of OASDI recipients would be subject to taxation of benefits. The commission acknowledged that the proposal had a "notch" problem, in that the extra dollar of income that would put one over the threshold would have had the effect of subjecting fully one-half (50%) of Social Security benefits to taxation, but trusted that it would be rectified during the legislative process.

In enacting the 1983 Social Security Amendments (P.L. 98-21), Congress adopted the commission's recommendation to tax Social Security benefits, but with a formula for determining taxable benefits that gradually increased as a person's income rose above the thresholds, up to a maximum of one-half (50%) of benefits. The formula calculated taxable benefits as the lesser of one-half (50%) of benefits or one-half (50%) of the excess of the taxpayer's provisional income over thresholds of $25,000 (single) and $32,000 (married couple). Provisional income was defined as total income plus certain tax-exempt income (tax-exempt interest) plus certain income exclusions plus one-half (50%) of Social Security benefits. At the same time, the tax credit for the

[15] U.S. Congress, Select Committee on Aging, *Hearings Before the Committee on Retirement Income And Employment, Oversight on Recommendations of the 1979 Social Security Advisory Council, Statement of Henry Aaron, Chairman of the Advisory Council on Social Security*, Comm. Pub. No. 96-230, March 11 and 13, 1980, p. 13.

[16] Social Security Administration, *Report of the National Commission on Social Security Reform*, January 1983, pp. 2-10 through 2-11, available at http://www.ssa.gov/history/reports/gspan.html.

elderly and disabled was expanded to provide additional tax relief for lower income elderly taxpayers.[17]

In 1993, the Social Security Administration's Office of the Actuary estimated that, if pension tax rules were applied to Social Security, the ratio of total employee Social Security payroll taxes to expected benefits for current recipients (in 1993) would be approximately 4% or 5%. The actuarial estimates were that for workers just entering the workforce,[18] the ratio would be, on average, about 7%. Because Social Security benefits replaced a higher proportion of earnings of workers who were lower paid and had dependents, and because women had longer life expectancies, the workers with the highest ratio of taxes to benefits would be single, highly paid males. The estimated ratio for these workers (highly paid males)entering the workforce in 1993 was 15%.

Applying the tax rules for private and public pensions presents practical administrative problems. Determining the proper exclusion would be complex for several reasons, including calculating the ratio of contributions to benefits for each individual worker's account when, unlike private pensions, several people may receive benefits on the basis of the same worker's account.

President Clinton proposed (as part of his FY1994 budget proposal) that the portion of Social Security benefits subject to taxation be increased from 50% to 85%, effective in tax year 1994. As under then-current law, only Social Security recipients whose provisional income exceeded the thresholds of $25,000 (single) and $32,000 (married couple) were to pay taxes on their benefits. Also as under then-current law, the first step was to add one-half (50%), not 85%, of benefits to total income. Because the thresholds and definition of provisional income did not change, the measure would only affect recipients already paying taxes on benefits. However, the ratio used to compute the amount of taxable benefits was increased from 50% to 85%. Taxing no more than 85% of Social Security benefits (the portion not based on contributions by a recipient, including highly paid males) would ensure that no one would have a higher percentage of Social Security benefits subject to tax than if the tax treatment of private and civil service pensions were actually applied.

The proceeds from the increase (from 50% to 85%) were slated to be credited to the Medicare Hospital Insurance program, which had a less favorable financial outlook than Social Security at that time. Doing so also avoided possible procedural obstacles (budget points of order that can be raised regarding changes to the Social Security program in the budget reconciliation process). This measure was included in the 1993 Omnibus Budget Reconciliation Act (OBRA), which passed the House on May 27, 1993.

The Senate version of the bill included a provision to tax Social Security benefits up to 85% but imposed it only after provisional income exceeded new thresholds of $32,000 (single) and $40,000 (married couple). When the House and Senate versions of the budget package were negotiated in conference, the conference agreement adopted the Senate version of the taxation of Social Security benefits provision and raised the thresholds to $34,000 (single) and $44,000

[17] The credit was originally created to provide a benefit to retirees that had taxable retirement income rather than nontaxable Social Security benefits.

[18] The average for all workers entering the work force is for all workers born in 1970 entering the workforce. The estimate for single males assumed the worker entering the work force in 1993 was 22 years old with steady income until retirement at either age 62 or the normal retirement age.

(married couple). President Clinton signed the measure into law (as part of P.L. 103-66) on August 10, 1993.

Appendix. Special Considerations Under Taxation of Benefits

Lump Sum Distributions

A Social Security beneficiary may receive a lump sum distribution of benefits for one or more prior years.[19] In this situation, a beneficiary has the option of choosing between two methods for calculating the taxable portion of the benefits for prior years: (1) the taxpayer may include all of the benefits for prior years in calculating the taxable benefits for the current year; or (2) the taxpayer may re-calculate the prior year taxable benefits using prior year income and take the difference between the recalculated taxable benefits and the taxable benefits reported in each prior year. In computing the taxable portion of benefits in prior years, the provisional income for the prior years is adjusted gross income plus tax exempt interest plus the excluded income (as detailed earlier) plus the addition (or add-back) of the adjustment for student loan interest, plus one-half (50%) of Social Security benefits.

Repayments

Sometimes a Social Security beneficiary must repay a prior overpayment of benefits. In this case, the calculation of taxable Social Security benefits is based on the net benefits—gross benefits less the repayment. Married taxpayers filing a joint tax return would use the total of the net Social Security benefits for the tax year received by each party (taxpayer plus spouse). If however, the repayment results in negative net Social Security benefits, there are two consequences for taxes: (1) there are no taxable Social Security benefits; and (2) the taxpayer may take a miscellaneous deduction[20] as part of itemized deductions, or a credit for the negative net Social Security benefits. If the negative net Social Security benefits are less than $3,000, the taxpayer must include negative net Social Security benefits in miscellaneous deductions for computing itemized deductions. If the negative net Social Security benefits are greater than $3,000, the taxpayer must compute the current year tax liability two ways: (1) using the negative balance as a miscellaneous deduction for computing itemized deductions; and (2) re-computing the taxes (without the overpayment income) for the prior years in which an overpayment was received and subtracting these amounts from the prior year taxes paid, and then subtracting this result (the sum of the differences in prior year taxes) from the current year tax liability. If the tax liability computed using the negative balance as a miscellaneous deduction is lower, the taxpayer claims the deduction. If the tax liability from re-computing prior years taxes is lower, the taxpayer claims a tax credit equal to the sum of the prior year tax differences.

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[19] This is not the lump-sum death benefit which is not subject to the federal income tax. An individual originally denied benefits, but approved on appeal, may receive a lump sum amount for the period when benefits were denied (which may be prior years).

[20] Miscellaneous itemized deductions are subject to a 2% floor. That is, they are included in itemized deductions to the extent they exceed 2% of adjusted gross income.

Coordination of Workers Compensation

Under current law, an individual's Social Security benefits (until the full retirement age), may be reduced by a portion of the Workers Compensation payments (payments from some other public disability program) received by the individual. Any reduction in Social Security benefits due to the receipt of Workers Compensation is considered to be a Social Security benefit and is used in determining the amount of Social Security benefits subject to taxation.

Treatment of Nonresident Aliens

Citizenship is not required for receipt of Social Security benefits. Aliens may receive benefits provided they have engaged in covered employment and otherwise meet eligibility requirements. In general, 85% of the Social Security benefits for nonresident aliens is subject to income tax (i.e., none of the thresholds apply). However, there are a number of exceptions to this general rule on the basis of tax treaties such that nonresident aliens or U.S. citizens living abroad may not have U.S. Social Security benefits subject to U.S. income taxes.[21]

Withholding

In general, withholding for a wage earner is based on the estimated income taxes for a full year of earnings at the periodic (weekly, bi-weekly, monthly, etc.) rate. Taxable Social Security benefits, and the associated taxes, are based on the amount of non-Social Security income earned by a recipient during the tax year. The Social Security Administration, without knowledge about the amount of other income received by a beneficiary, is unable to properly determine the amount of taxes that should be withheld from Social Security benefits. Like other non-wage earners, Social Security recipients can make quarterly estimated income tax payments. The Uruguay Round Agreements Act (P.L. 103-465) amended the Internal Revenue Code (IRC) to allow individuals to request that monies be withheld from certain federal payments to satisfy their income tax liability (this is commonly referred to as voluntary tax withholding). An amendment to Section 207 of the Social Security Act allowed this voluntary tax withholding from Social Security benefits.[22] Voluntary tax withholding became effective with payments issued in February 1999.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16) permitted voluntary withholding from Social Security benefits at rates of 7%, and equal to the bottom three tax bracket tax rates (currently 10%, 15%, and 25%). This P.L. 107-16 change will expire on December 31, 2010.

Aliens residing outside the United States are subject to different tax withholding rules. Section 871 of the Internal Revenue Code imposes an arbitrary rate of tax withholding (30%) on almost all of the U.S. income of nonresident aliens, unless a lower rate is fixed by treaty. Thus, 30% of 85% (or 25.5%) of a nonresident alien's Social Security benefits may be withheld for federal income taxes.

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[21] Internal Revenue Service, *Publication 915* provides a lists of the countries whose citizens (as nonresident aliens) are exempt from U.S. income taxes of Social Security benefits, and countries where residing U.S. citizens are exempt.

[22] Because they are not subject to the federal income tax, Supplemental Security Income payments, Black Lung payments, Medicare premium refunds, Lump Sum Death Payments, returned check re-issuances, and benefits due before January 1984, are not subject to voluntary tax withholding.

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