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# Social Security: Calculation and History of Taxing Benefits

Updated March 23, 2005

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# Social Security: Calculation and History of Taxing Benefits

## Summary

The Social Security system provides monthly benefits to qualified retirees, disabled workers, and their spouses and dependents. Until 1984 (P.L. 98-21), Social Security benefits were exempt from the federal income tax. In 1983, Congress made up to 50% of Social Security (and Tier I Railroad Retirement) benefits taxable for taxpayers whose income plus one-half (50%) of Social Security (and Tier I) benefits exceeds $25,000 for an individual or $32,000 for a married couple filing a joint tax return. The 1993 omnibus budget reconciliation bill (P.L. 103-66) introduced a two tier system for the calculation of taxable Social Security and Tier I benefits, with recipients whose incomes exceed $34,000 (single) or $44,000 (married couples), taxed on up to 85% of benefits. The proceeds from the taxation of Social Security benefits for the first tier (using the 50% ratio) go to the Old-Age and Survivors Insurance trust fund (OASI), and the Disability Insurance (DI) trust fund. The proceeds of the tax associated with the second tier (using the 85% ratio) go to the Health Insurance trust fund for Medicare.

Preliminary data for tax year 2002, show that 10.8 million income tax returns had taxable Social Security benefits, and that these returns included $94.7 billion in Social Security benefits in taxable income. In 2002, total Social Security benefits paid were $453.8 billion, resulting in 20.9% of benefits subject to the income tax. Because not all Social Security benefits are taxable, information from tax returns does not reflect all Social Security beneficiaries. In addition, for married couples filing a joint tax return there may be more than one beneficiary. The Congressional Budget Office (CBO) has estimated, using 2000 population and income levels with 2003 provisions of law, that 39% (or 15.6 million) Social Security beneficiaries are impacted by the income taxation of Social Security benefits.

In the 108th Congress, 16 bills were introduced, but did not pass either chamber, that would have liberalized or repealed the taxation of Social Security benefits. In the 109th Congress, three bills (H.R. 137, H.R. 179, and H.R. 1014) have been introduced which would impact the taxation of Social Security benefits. In addition, the Senate Budget Resolution (S.Con.Res. 95) would alter the taxation on benefits. This report will be updated as warranted by legislative activity.

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# Social Security: Calculation and History of Taxing Benefits

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.

## 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

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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*, 2003, available 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.

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.

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.

[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.

## 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 taxable Social Security 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 illustrate how taxable Security benefits may be calculated for a single retiree in tax year 2004. The retiree is over age 65, and receives $11,117 in annual Social Security benefits — the average in July 2004 for a retiree.[6] The examples include other (non-Social Security) income of $22,000 or $32,000.

*Example One*. The single retiree received $11,117 in Social Security benefits and has other income of $22,000 for the tax year.

| | | |
|---|---|---|
| Provisional income | = | $27,558<br>[Other income ($22,000) *plus*<br>One-half (50%) of Social Security or Tier I benefits ($5,558)] |
| First tier threshold | = | $25,000 |
| Excess | = | $2,558<br>[Provisional income ($27,558) *minus* First tier threshold ($25,000)] |
| Taxable Social Security benefits | = | $1,279<br>[Lesser of: one-half (50%) of Social Security or Tier I benefits ($5,558), or<br>one-half (50%) of excess ($1,279)] |

*Example Two*. The single retiree received $11,117 in Social Security benefits and has other income of $32,000 for the tax year.

| | | |
|---|---|---|
| Provisional income | = | $37,558<br>[Other income ($32,000) *plus*<br>One-half (50%) of Social Security or Tier I benefits ($5,558)] |
| First tier threshold | = | $25,000 |
| Excess | = | $9,000<br>[Maximum of : provisional income ($37,558) *minus* first tier threshold ($25,000), or<br>$9,000 (difference between the first and second tier thresholds)] |

[6] The average monthly benefit for a retiree in July 2004 was $926.40. This would be an annual benefit amount of $11,117. Information on current monthly benefits is available at [http://www.ssa.gov/policy/docs/statcomps/oasdi_monthly/2004-07/table2.html].

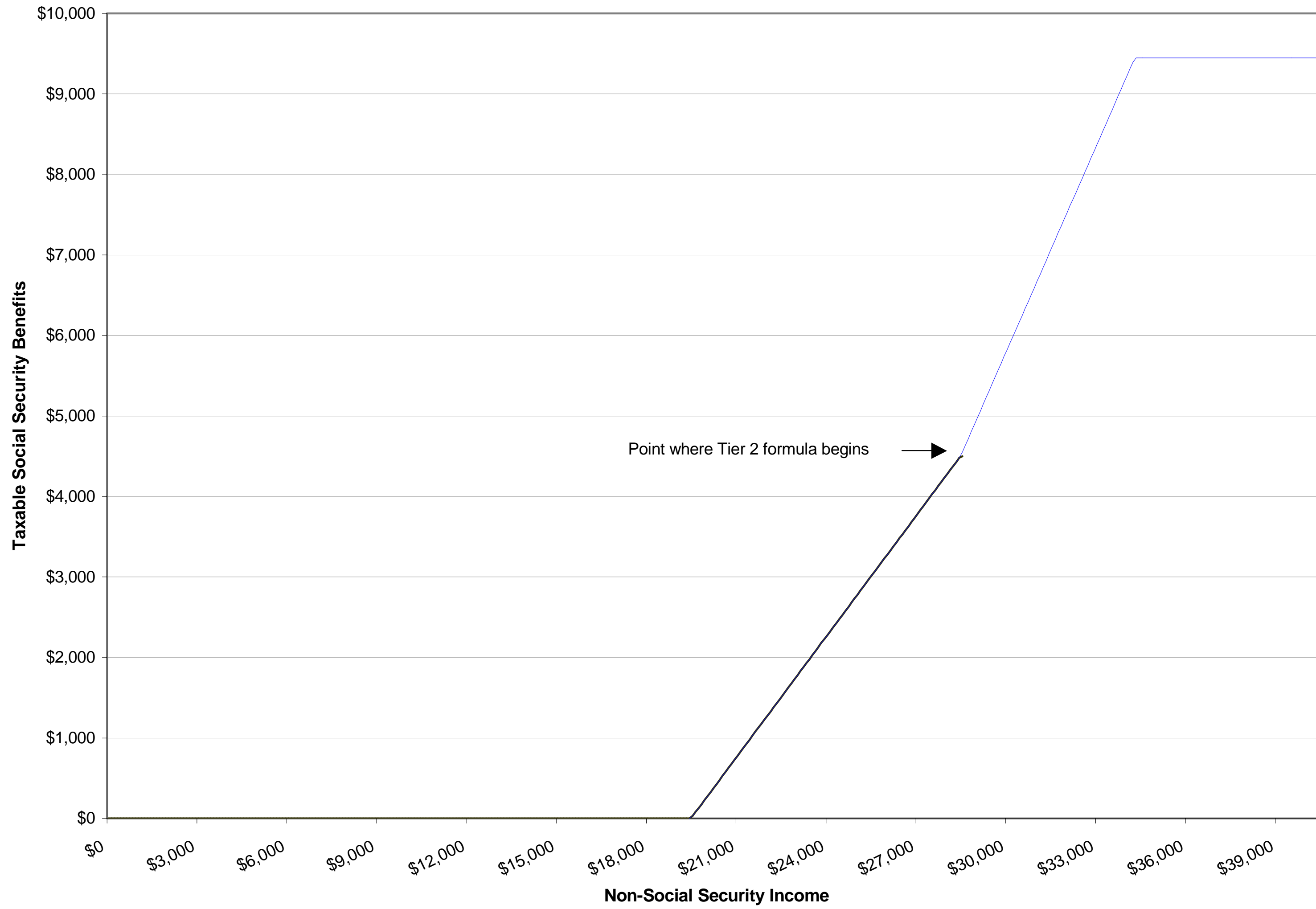
| | | |
|---|---|---|
| First tier taxable benefits | = | $4,500<br>[Lesser of: one-half (50%) of Social Security benefits ($5,558), or<br>one-half (50%) of excess ($4,500)] |
| Second tier threshold | = | $34,000 |
| Excess | = | $3,558<br>[Provisional income ($37,558) *minus* Second tier threshold ($34,000)] |
| Second tier taxable benefits | = | $3,024<br>[85% of excess ($3,558 *times* .85 = $3,024)] |
| Taxable Social Security benefits | = | $7,524<br>[Lesser of: 85% of Social Security benefits ($9,449),or<br>second tier taxable benefits ($3,024) *plus*<br>lesser of:<br>one-half (50%) of Social Security or tier 1 benefits ($5,558); or<br>$4,500 (the tier 1 maximum)] |

**Figure 1** shows taxable Social Security benefits for a single retiree with Social Security benefits of $11,117 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%. 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**, the line representing taxable Social Security benefits becomes flat at the taxable income level ($34,564) where taxable Social Security benefits are at the maximum of 85% of benefits.

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.

**Figure 1. Taxable Social Security Benefits as Non-Social Security (and Provisional) Income Increases For A Single Retiree with $11,117 in Annual Social Security Benefits, Tax Year 2004**




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

**Lump sum distributions.** A Social Security beneficiary may receive a lump sum distribution of benefits for one or more prior years.[7] 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[8] 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.

**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.

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[7] 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).

[8] 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.

**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 based on 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.[9]

**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.[10] Voluntary tax withholding became effective with payments issued in February 1999.

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.

**State Taxation.** While 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

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[9] *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.

[10] 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 reissuances, and benefits due before Jan. 1984, are not subject to voluntary tax withholding.

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[11] in the state calculation of income.

In tax year 2003, 28 of the 42 states (and the District of Columbia) with a personal income tax, fully excluded Social Security benefits from the state personal income tax. Fourteen (14) states tax all, or part, of Social Security benefits. **Table 2** shows the states taxing all or part of Social Security benefits for state personal income taxes in tax year 2003.

### Table 2. State Income Taxation of Social Security Benefits, Tax Year 2003

| | |
|---|---|
| **States taxing all or part of the federal taxable Social Security benefits** | Connecticut, Iowa, Kansas, Minnesota, Missouri, Montana, Nebraska, New Mexico, North Dakota, Rhode Island, Utah, Vermont, West Virginia, Wisconsin |
| **States not taxing Social Security benefits** | Alabama, Arizona, Arkansas, California, Colorado, 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 |
| **States without a state personal income tax** | Alaska, Florida, Nevada, New Hampshire[a], South Dakota, Tennessee, Texas, Washington, Wyoming |

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

a. New Hampshire does tax interest and dividend income.

## Impact of Taxing Social Security Benefits

In 2002, total Social Security benefits paid were $453.8 billion.[12] Preliminary tax year 2002 data[13] indicate that 10.8 million taxpayers had taxable Social Security benefits totaling $94.7 billion, or 20.9% of total Social Security benefits. The Congressional Budget Office (CBO) has estimated, for 2003 law and 2000 levels of income and population, that 39% of all beneficiaries are impacted by the taxation of Social Security benefits, and that the total income tax associated with Social Security benefits equals 5.2% of total Social Security benefits.

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

[12] Social Security Administration, *Social Security and Medicare Benefits*, updated Feb. 20, 2004, available online at [http://www.ssa.gov/OACT/STATS/table4a4.html].

[13] Internal Revenue Service, "Individual Income Tax Returns, Preliminary Data, 2002," *Statistics of Income, SOI Bulletin*, winter 2003-2004, vol. 23, no. 3.

**Table 3** shows the CBO estimates of the number of Social Security beneficiaries, the number of beneficiaries impacted by the taxation of Social Security benefits, and the percent of beneficiaries impacted by taxation by level of income (cash income for the tax unit plus capital gains realizations). As shown in **Table 3**, the current tax structure results in a higher percentage of beneficiaries impacted by taxation at higher income levels. The percentage of Social Security beneficiaries impacted increases with the income level, with more than 90% of beneficiaries with an income of $40,000 or more impacted by the taxation of Social Security benefits.

### Table 3. Number and Percentage of Beneficiaries with Taxable Social Security Benefits By Income Class Under 2003 Law, Population and Income at 2000 Levels

| Level of income | Number of Social Security beneficiaries (in thousands) | Number of beneficiaries affected by taxation (in thousands) | Percent of beneficiaries affected by taxation |
|---|---|---|---|
| Less than $10,000 | 7,157 | 2 | 0% |
| $10,000 - $15,000 | 4,845 | 7 | 0% |
| $15,000 - $20,000 | 3,509 | 12 | 0% |
| $20,000 - $25,000 | 3,439 | 22 | 1% |
| $25,000 - $30,000 | 2,854 | 360 | 13% |
| $30,000 - $40,000 | 5,225 | 2,237 | 43% |
| $40,000 - $50,000 | 3,918 | 3,598 | 92% |
| $50,000 - $100,000 | 6,705 | 6,608 | 99% |
| Over $100,000 | 2,737 | 2,723 | 100% |
| Total | 40,389 | 15,569 | 39% |

**Source:** Table prepared by the Congressional Research (CRS) from Committee on Ways and Means, 2004 Green Book, Background Material Within the Jurisdiction of the Committee on Ways and Means, Table 1-25, prepared by the Congressional Budget Office (CBO).

**Notes:** Level of income is cash income (based on tax filing unit) plus capital gains realizations Number of Social Security beneficiaries includes beneficiaries under and over age 65.

**Table 4** shows the CBO estimates of the amount of Social Security benefits, and the income taxes associated with Social Security benefits by level of income (cash income for the tax unit plus capital gains realizations). As shown in **Table 4**, as income increases, the taxes on Social Security benefits became a larger share of benefits reflecting the formula for calculating taxable benefits and the income tax rates.

**Table 4. Social Security Benefits and Taxes on Social Security Benefits By Income Class Under 2003 Law, Population and Income at 2000 Levels**

| 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 | $44,745 | $ - | 0% |
| $10,000 - $15,000 | $44,827 | $2 | 0% |
| $15,000 - $20,000 | $31,887 | $4 | 0% |
| $20,000 - $25,000 | $33,025 | $14 | 0% |
| $25,000 - $30,000 | $27,332 | $48 | 0% |
| $30,000 - $40,000 | $49,036 | $650 | 1% |
| $40,000 - $50,000 | $39,011 | $1,948 | 5% |
| $50,000 - $100,000 | $72,224 | $9,424 | 13% |
| Over $100,000 | $35,351 | $7,386 | 23% |
| Total | $377,438 | $19,476 | 5% |

**Source:** Table prepared by the Congressional Research (CRS) from Committee on Ways and Means, 2004 Green Book, Background Material Within the Jurisdiction of the Committee on Ways and Means, Table 1-25, prepared by the Congressional Budget Office (CBO).

**Notes:** Level of income is cash income (based on tax filing unit) plus capital gains realizations. Number of Social Security beneficiaries includes beneficiaries under and over age 65. Social Security benefits and taxes on Social Security benefits are understated because of benefits paid abroad, death of recipients before March interview, and exclusion of institutionalized beneficiaries.

As previously noted, because of the thresholds not all Social Security benefits are taxable. **Figure 2** shows how taxable Social Security benefits impact taxable income for a given level of Social Security benefits ($11,117) for a single retiree in tax year 2004.[14] The gap between the line for Social Security benefits and taxable Social Security benefits is the untaxed portion of Social Security benefits. The growth in taxable Social Security benefits as non-Social Security income increases is mirrored in the difference between taxable income without taxable Social Security benefits and taxable income with Social Security benefits.

**Figure 3** shows how different levels of Social Security benefits impact taxable income for a single retiree with either $20,000 or $30,000 in non-Social Security income.[15] In **Figure 3**, the Social Security benefits increase until they reach the annual maximum benefits for a person receiving benefits at age 62 - $17,064.

Because of the thresholds, retirees with the same level of Social Security benefits, but with different levels of non-Social Security income will have different after-tax (or disposable) income. **Figure 4** shows for a given level of Social Security

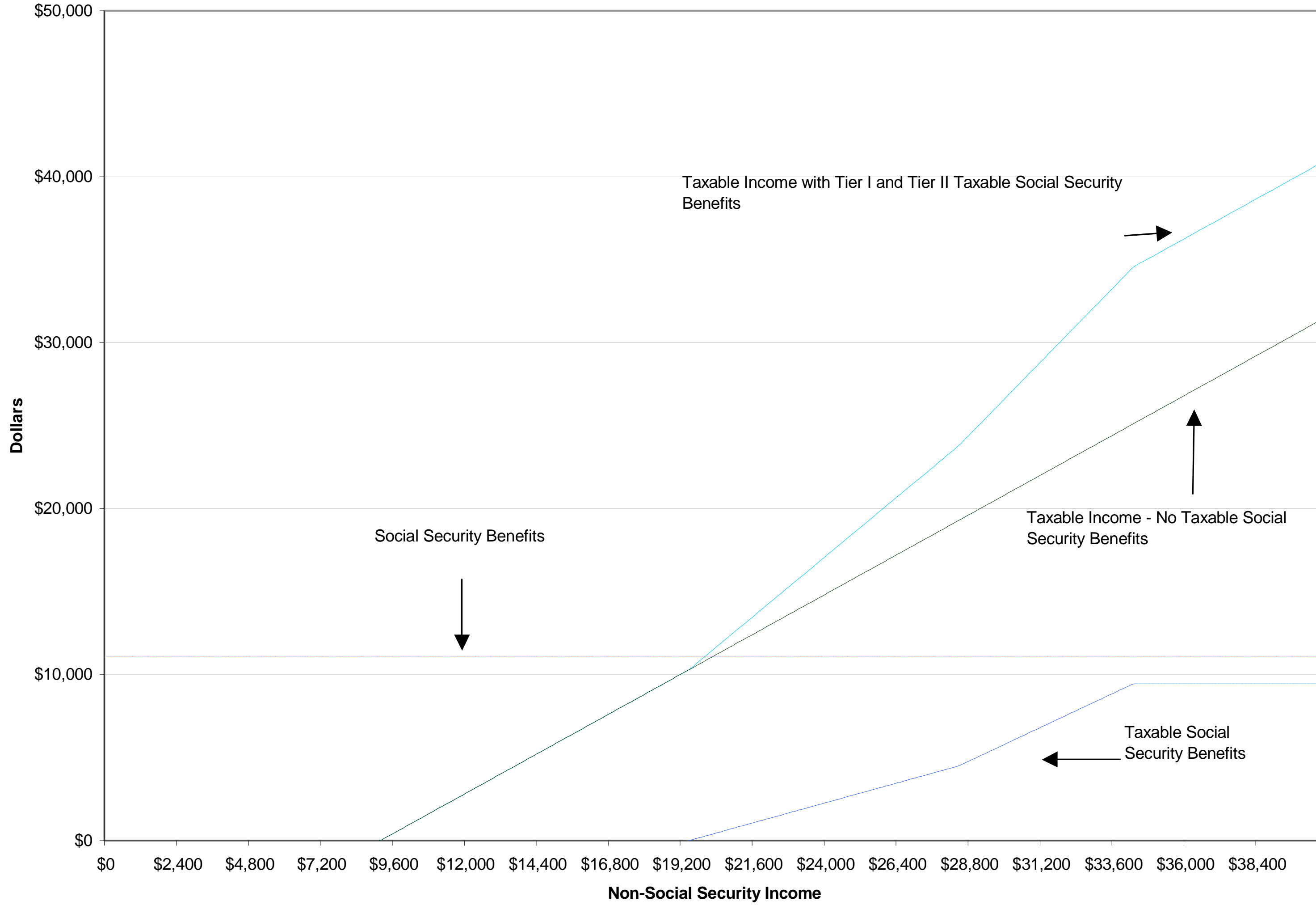
[14] The retiree uses the standard deduction including the additional standard deduction for elderly taxpayers. For tax year 2004, the standard deduction for a single is $4,850, the additional standard deduction for a single aged taxpayer is $1,200, and the personal exemption is $3,100. This is a total subtraction from income of $9,150 for the personal exemption and standard deduction.

[15] Ibid.

benefits ($11,117) the total and after-tax income of a single retiree at different levels of non-Social Security income in tax year 2004.[16] Alternatively, **Figure 4** can be viewed as a comparison of total and after-tax income for single retirees with different levels of non-Social Security income, but the same level of Social Security benefits ($11,117).

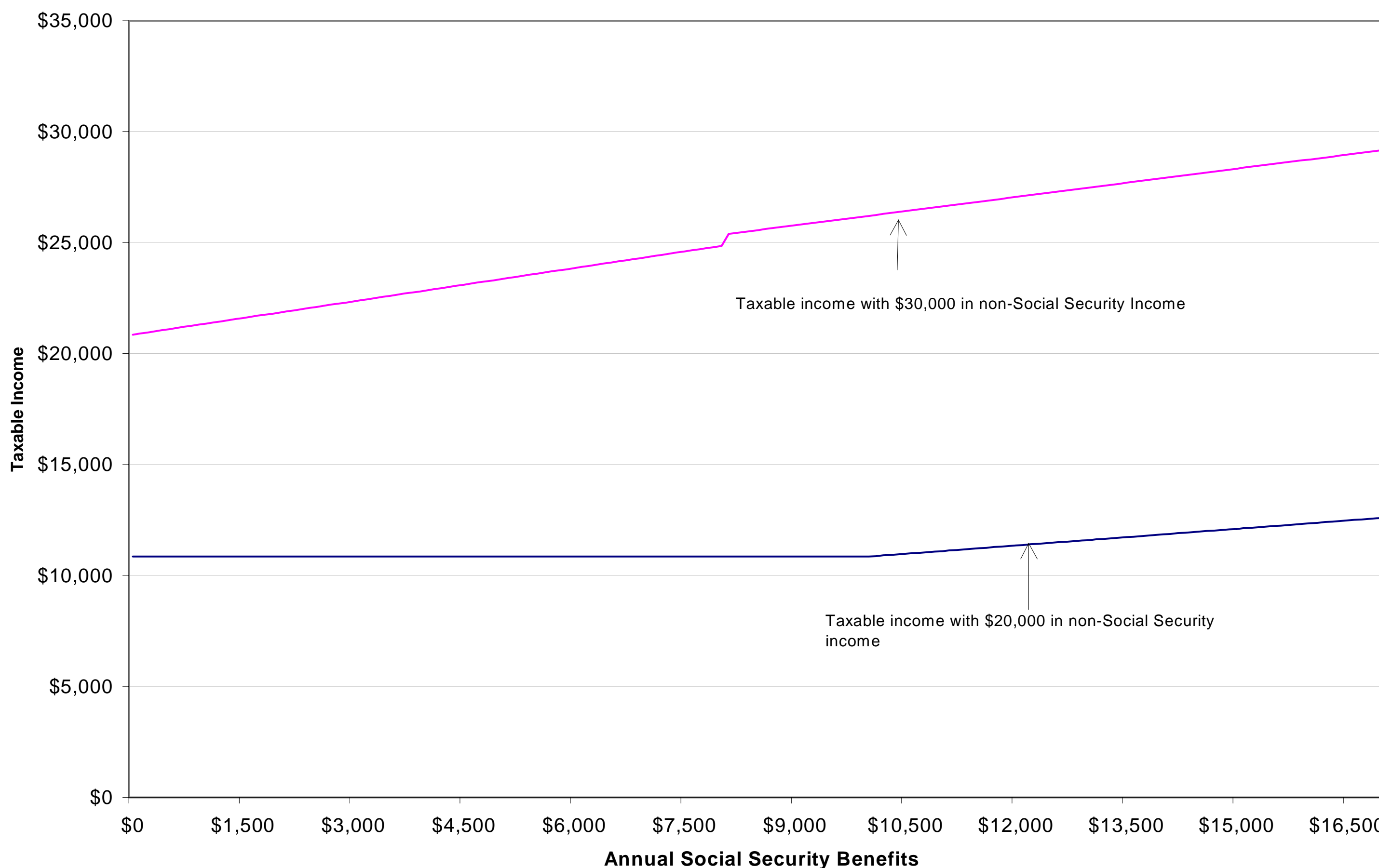
[16] Ibid

**Figure 2. Social Security and Taxable Income as Non-Social Security (and Provisional) Income Increases For A Single Retiree with $11,117 in Annual Social Security Benefits, Tax Year 2004**



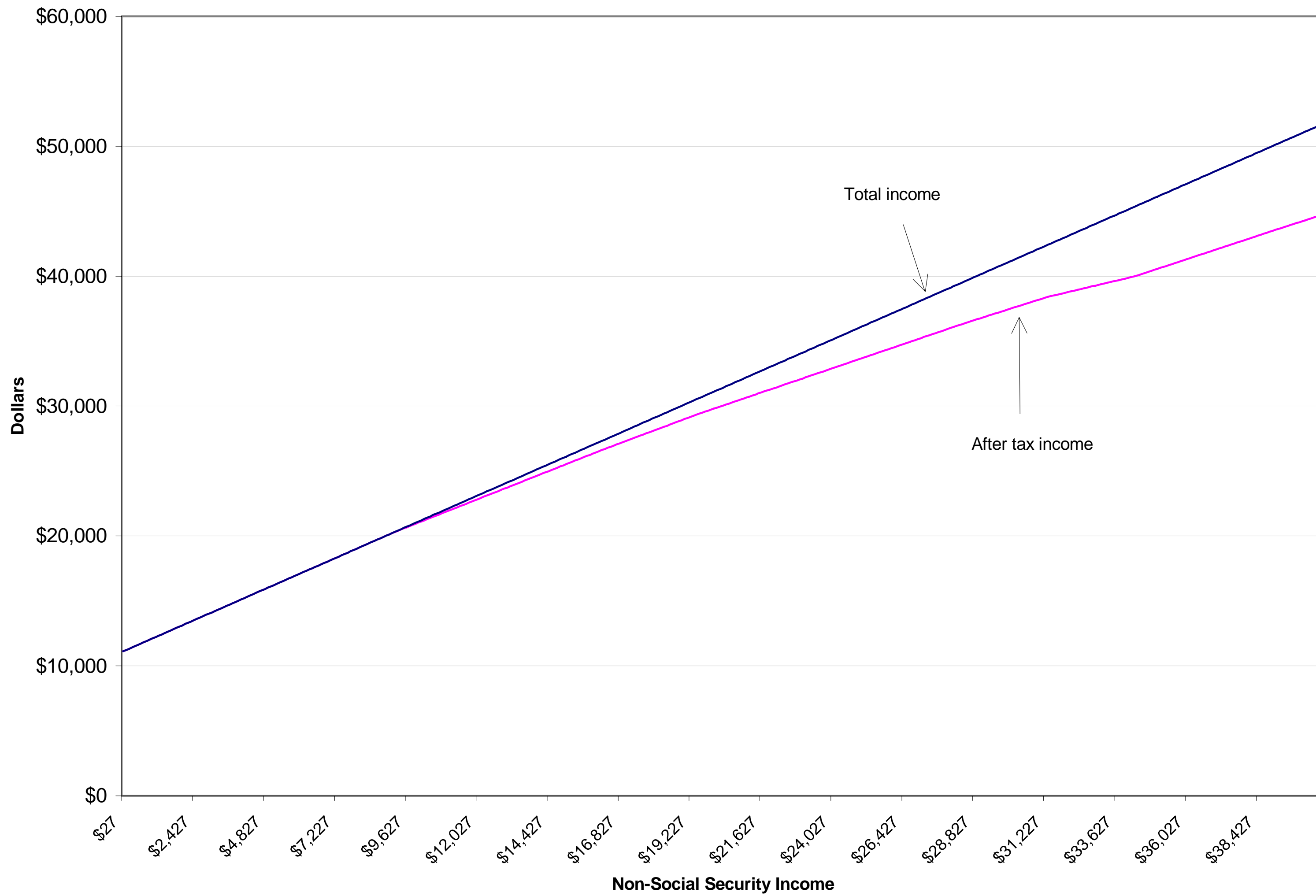

**Source:** Table prepared by the Congressional Research Service (CRS). The retiree uses the standard deduction for taxpayers aged 65 or over or blind.

**Figure 3. Taxable Income For A Single Retiree with $20,000 or $30,000 in Non-Social Security Income as Social Security Benefits Increase, Tax Year 2004**




**Source:** Table prepared by the Congressional Research Service (CRS). The retiree used the standard deduction for taxpayers aged 65 or over or blind. Social Security benefits increase to $17,064 - the maximum benefit in 2004 for a person that began receiving benefits at age 62.

**Figure 4. Total and After-Tax Income For A Single Retiree with $11,117 in Annual Social Security Benefits, Tax Year 2004**




**Source:** Table prepared by the Congressional Research Service (CRS). The retiree uses the standard deduction for taxpayers aged 65 or over or blind.

**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, based on 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 2003, the Trustees Report reflected income to OASDI of $13.4 billion from the taxation of benefits, or 2.1% of the combined income for both funds.[17] Income from the taxation of benefits in the HI fund were $8.3 billion, or 4.7% of total fund income.[18] Income taxes transferred to support railroad retirement programs were comparatively smaller, $336 million, in 2002.[19]

## 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.[20]

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 FICA taxes is not subtracted to determine income subject to the federal income tax, and is therefore taxed. The employer's

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[17] Social Security Administration, *2004 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds*, Mar. 2004, available at [http://www.ssa.gov/OACT/TR/TR04/tr04.pdf].

[18] Center for Medicare and Medicaid Services, *2004 Annual Report of the Board of Trustees of the Federal Hospital Insurance Trust and Federal Supplementary Medical Insurance Trust Funds*, Mar. 2004, available at [http://www.cms.hhs.gov/publications/trusteesreport/2004/tr.pdf].

[19] Railroad Retirement Board, 2003 Annual Report, available at [http://www.rrb.gov/opa/pdf/03annrpt.pdf].

[20] 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.

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.[21] 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 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,[22] 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.

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[21] 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, Mar. 11 and 13, 1980, p. 13.

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

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 elderly and disabled was expanded to provide additional tax relief for lower income elderly taxpayers.[23]

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*,[24] 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 based on 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

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

[24] 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.

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

## Legislation in the 108th Congress

In the 108th Congress, 16 bills were introduced, none of which passed in either chamber, that would have altered the taxation of Social Security benefits. Some of the legislation would have indexed the current tax thresholds, while other legislation would have repealed part, or all, of the taxation of benefits.

## Legislation in the 109th Congress

In the 109th Congress, three bills (H.R. 137, H.R. 179, and H.R. 1014) have been introduced that would eliminate the taxation of Social Security benefits at the 85% level, and thereby restore Social Security back to the pre-1993 calculations. The Senate Budget Resolution, S.Con.Res. 18, as introduced contained reconciliation instructions to the Senate Finance Committee to reduce revenues under the committee's jurisdiction (i.e., the instructions provided for a given level of tax cuts). During floor debate, an amendment (S.Amend. 241, proposed by Senator Bunning) was passed which increased the level of tax cuts in the reconciliation instructions for the Senate Finance Committee. Another amendment (S.Amend. 243, proposed by Senator Conrad) was also passed. This amendment created a Sense of the Senate provision that provided that the tax cuts in the budget resolution are assumed to include repeal of the 1993 tax change which subjected up to 85% of Social Security benefits to taxation. The revenue loss to the Medicare Hospital Insurance Trust Fund is to be replaced, and if inclusion of these provisions results in a total tax cut exceeding the reconciliation instructions, the additional revenue loss is to be offset by closing corporate tax loopholes