Social Security Benefits Taxation: Issues And Present Status

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ABSTRACT

Taxation of Social Security benefits was introduced in 1983 as part of a general restructuring of Social Security. As part of the 1993 Omnibus Budget Reconciliation Act, taxation of benefits was revised and expanded. Inclusion of social security benefits as part of taxable income is determined by comparing a modification of adjusted gross income and half of social security benefits to threshold amounts established in each tax law. Unlike most amounts used to determine tax, the thresholds were not subject to indexation or revision. This paper examines the current state of social security taxation in light of personal income changes, social security benefit revisions and federal income tax rate and bracket modifications that have taken place over the fourteen years since the last revision in taxation of benefits.

Keywords: Social Security Benefits Taxation; Budget Reconciliation Act; Social Security Benefits Revision

INTRODUCTION

Until 1982, social security retirement benefits were not subject to federal tax. During the last major restructuring of the program in that year, taxation of benefits was proposed as a way to reduce the net cost of the program and as way of allowing social security benefits to be taxed in a manner that approximated the treatment of other sources of employment income. According to Pattison and Harrington (1993), the initial proposal provided for the inclusion of 50% of benefits received as part of taxable income. This would have no effect on individuals with low or no income in addition to social security benefits because taxable income would still be zero. Individuals with higher incomes would be progressively affected depending on their tax bracket. In an effort to further limit taxation of benefits to higher-income taxpayers, the Congress chose to establish a threshold amount below which benefits would not be taxed. Based on then-existing thresholds for taxation of unemployment compensation, these thresholds were established as $32,000 for married couples filing joint returns and $25,000 for all others. To determine taxation of benefits, 50% of social security benefits are added to modified adjusted gross income (MAGI) (basically AGI modified to include such normally tax-exempt items as municipal bond interest) to arrive at “provisional income”. The 50% maximum was based on the fact that 50% of payments to the Trust Fund were matching amounts paid by employers that had never been subject to tax while the 50% paid by employees had already been included in taxable income. 50% of the amount by which provisional income exceeds the appropriate threshold is includable in taxable income. This 50% rate, termed the phase-in rate, is the percentage of each $1 increase in MAGI that is added to taxable social security benefits. As discussed in our 2003 paper, a $1 increase in MAGI thus produces a $1.50 increase in taxable income, so during this phase-in period marginal tax rates are effectively 50% higher. At the time the law became effective, 15% bracket taxpayers effectively faced a marginal rate of 22.5% while 28% bracket taxpayers paid a 42% marginal rate. Phase-in continued up to a maximum of 50% of benefits received.

The 1983 legislation was a compromise between the original proposal for full inclusion of 50% of benefits and a gradual inclusion based on the higher income threshold amount. According to Pattison and Harrington (1993), Congress purposely did not index the threshold amounts. The result was intended to be a gradual increase in the inclusion of benefits in taxable income. “In a sense, the thresholds are already being lowered, gradually but automatically, because they are given in fixed, nominal amounts. As incomes rise, whether through growth in real

incomes or through inflation, an increasing portion of the beneficiary population will have incomes above the thresholds and will therefore have some of their benefits taxed." (Pattison and Harrington, 1993, p. 3) Numerous proposals to index or modify the threshold amounts have been made since 1983 and all have failed.

Taxation of social security benefits was revisited in 1993 in the Omnibus Budget Reconciliation Act. According to Pattison (1994) the Clinton Administration initially proposed that both the phase-in rate and maximum percentage of benefits taxed be increased to 85%, subject to the thresholds already established in 1983. The rationale for the increase to 85% was based on an established principle of annuity taxation called the exclusion ratio. This ratio is the relationship of total (after-tax) payments made by the annuitant to total expected pay out over the life of the annuity. Stated as a percentage and multiplied times each annuity payment, it determines the amount of each is payment that is not included in taxable income. In a Social Security Administration study cited by Pattison and Harrington (1993), the group of social security recipients with the highest exclusion ratio was high-income, never-married males. The rate for this group was 15%. Since all other recipients had lower rates, the 15% exclusion percentage (termed an 85% inclusion or phase-in percentage) was adopted as a conservative estimate of the maximum amount of benefits that should be taxable.

Once again, while adopting the proposed 85% phase-in rate and the 85% maximum for taxation of benefits, Congress further restricted the application of these higher rates to high-income beneficiaries. Leaving the 50% phase-in rate and threshold amounts intact, the 1993 Act established new, higher thresholds to determine the point at which 85% inclusion would begin. As in 1983, bracket points were fixed without provision for future indexation or modification as shown in Table 1:

Table 1: Bracket points for phase in of benefits by filing status

Filing Status:	**Bracket point for 50% Inclusion (1983 Act):**	**Bracket Points for 85% Inclusion (1993 Act):**
Single, Head-of-Household	$25,000	$34,000
Married Filing Jointly	$32,000	$44,000

Since any individual subject to the higher bracket percentages would already be subject to inclusion at the old rates, only individuals already subject to inclusion saw an increase in tax on their benefits as a result of the 1993 Act. Pattison (1994) estimated that 81.8% of beneficiaries received all their benefits free of tax under both the 1983 and 1993 Acts. Another 7.6% paid tax under the 1983 Act but saw no increase under the 1993 Act because they did not exceed the higher threshold amounts. The remaining 10.6% saw an increase in tax under the new law. As might be expected, the family incomes of these individuals were heavily concentrated in the top 30% of all families. Again from our 2003 article, during inclusion at the 85% rate marginal income tax rates were even higher than under the previous Act. 15% bracket taxpayers paid an effective 27.75% and those in the 28% bracket had an effective marginal tax rate of 51.8%.

Factors Affecting Social Security Benefits Taxation Since 1993

While the methods used to determine the taxation of social security benefits are unchanged from those described above, other factors affecting the extent of benefits taxation have undergone significant changes. First, there has been an increase in both real and nominal income levels for those in retirement. Second, social security benefit amounts have risen due to changes in income, program structure, and family income composition. Finally, the taxation of income has changed due to the incremental effects of indexation on bracket points and deductible amounts, as well as the changes in tax rates, deductible amounts and bracket points implemented since 2000.

CHANGES IN INCOME AFFECTING BENEFITS TAXATION- 1993-2008

In 2008, the last year for which income amounts are available in the Social Security Administration's Office of Policy's Report on the Income of the Population 55 and Older (Table 3.A2) (2010), the median family income for married couples age 65 and older was $42,619- an increase of over $5,000 since the 2004 survey. Unmarried individuals over 65 had a median income of $17,157, less than the $18,676 reported in 2004. According to Social Security's Income of the Aged Chart Book (2010), social security benefits make up 36.5% of the income for these groups (vs. 38% in 2004)- a percentage which has remained stable over time.

Although no major changes were made in the benefits formula, maximum benefit amounts climbed rapidly during this period. The increase was caused by inflation adjustment and the yearly increases in the amount of income subject to social security tax that took place during this period. Maximum monthly individual benefits (benefits for individuals who earned at least the social security maximum every year during their working lifetimes) increased from $1,128 in 1993 to $2,191 in 2010- a 94% increase (Fast Facts and Figures, Social Security Administration, 2010).

Another factor increasing benefits for married couples during this period was the increased participation of both members in the workforce and the resulting increase in combined family benefits. When the social security system was first established, retired married couples consisted primarily of a wage earner and a spouse who had never worked outside the home. From the earliest days of the system, married couples received 50% more than single individuals in the form of a spousal benefit. The last decade has seen the continuation of a long-term shift away for this traditional pattern to one in which both the husband and wife receive individual benefits. According to the Social Security Administration Office of Policy, (2010), the proportion of women 62 or older who received benefits base on their husband's earnings records only decreased from 57% in 1960 to 29% in 2007. At the same time the proportion of women with entitlements based on their own as well as their husband's work record rose from 5% in 1960 to 28% in 2007. Under current rules, the couple receives the greater of the spousal benefit or the benefit earned by the spouse with the lowest income in addition to the higher income spouse's benefits. As the differences between male and female income declines, more and more couples will receive two individual benefits that together are close to double the average single amount rather than an individual benefit and the old 50% spousal benefit.

CHANGES IN INCOME TAXATION THAT AFFECT BENEFITS- 1993-2008

Several changes in income taxation have occurred since 1993 that affect benefits taxation. The old 15% and 28% rate structure in effect in 1993 has become a 10%, 15% and 25% bracket progression. Effective marginal rates for income above the 50% inclusion point thus become 15%, 22.5% and 37.5% respectively and 18.5%, 27.75%, and 46.25% at the 85% inclusion point (VanZante and Fritzsch, 2003). Tax bracket points have increased due to indexation, and the bracket point at the beginning of the 15% and 25% brackets for married couples has been increased to twice the single amount, eliminating part of the "marriage penalty". In addition to indexation, standard deductions for married have been increased to twice the single rate. As will be illustrated below, the effect of these changes for married couples has been to increase the amount of income they can receive before income is taxed (and social security inclusion takes place) in the 25% bracket. This bracket structure will remain in effect until 2012 unless earlier modified by the Congress. In 2010, the bottom three tax brackets were as shown in Table 2 below.

Table 2: 2010 Tax Rates

Married Filing Jointly

Tax Rate	Over($)	But Not Over($)
10%	0	16,750
15%	16,750	68,000
25%	68,000	137,300

Single

Tax Rate	Over($)	But Not Over($)
10%	0	8,375
15%	8,375	34,000
25%	34,000	82,400

Note that "Marriage Penalty" elimination has resulted in bracket points for joint returns that are twice the amounts for single taxpayers.

MEASURING CURRENT LEVELS OF BENEFITS TAXATION

In prior studies of the effects of benefits taxation on social security recipients, the Social Security Administration's Office of Economic Research used a Simulated Tax and Transfer System (STATS) microsimulation model to determine the effect of various policy alternatives (Pattison and Harrington, 1993). The STATS model recreated the tax returns for each individual beneficiary using alternative assumptions about benefits taxation.

As an alternative method of estimating taxation of benefits which we described in our 2009 article examining 2004 data, we determined the amount of income required to result in taxation of social security benefits for married couples filing jointly and for single individuals. Having determined these amounts, we compared them to the distribution of incomes for individuals receiving benefits as provided by Social Security to calculate the percentage of retirees currently subject to benefits taxation at the 50% and 85% inclusion levels. This article performs the same analysis using the most current (2008) income data and compares the results to those in our 2009 paper.

Percentage of Beneficiaries Subject to Benefits Taxation

To determine the amount of income necessary to result in taxation of benefits for single and married individuals, we assumed the social security benefits amount to 36.5% of total retirement income, the average amount mentioned above. This average amount approximates the percentage for couples and individuals in the middle income ranges for retirees. According to the 2008 Income of the Aged Chartbook (Shares of Aggregate Income by Income Level), individuals in the lowest quintile have a higher percentage of income from social security. However, income for this group is so low that none would be subject to taxation of benefits. Likewise, individuals in the highest quintile receive a larger portion of income from wages and proportionately less from other sources. Most of this group is not yet really retired. The 36.5% portion is thus representative of the middle income ranges where benefits inclusion in taxable income occurs.

Since only 50% of benefits are includable in the provisional income amount used to determine if benefits are taxable, 18.25% of income (half of social security) is excluded. To reach the $32,000 minimum, a couple would have to a total income of $39,115 (including $14,115 in social security benefits). This is just below the $42,619 median income earned by couples in retirement. Using Social Security's Distribution of Incomes for Married Couples over 65 (2010, Table 5.A2), 44% of married couples would still not be subject to any taxation of benefits. To have benefits included at the 85% rate, a couple would have to have at least $53,823 in total income (including $19,654 in social security) to exceed the $44,000 provisional income minimum. An additional 21% of retired couples would fail to exceed this amount, having up to 50% of their benefits included in taxable income but not being subject to the 85% rate. The remaining 35% would have at least some 85% inclusion.

Single individuals are subject to lower provisional income minimums and also have lower incomes and social security benefits. With 36.5% of income in the form of social security, a single individual must exceed $30,580 (including $11,165 in social security benefits) before any benefits are taxable and $41,590 (including $15,180) before any benefits are includable at the 85% rate. Again using Social Security's income distribution for unmarried individuals (2010, Table 5.A2), about 82% would pay no tax on benefits, another 11% would have inclusion at the 50% rate but not at the 85% rate, and the other 7% would have some benefits included at the 85% rate. Comparing these findings to the original outcomes of the 1993 study by Social Security cited above and to those from our 2009 paper (2004 data) results in the amounts shown in Table 3:

Table 3: Percentage of Over-65 Beneficiaries Paying Income Tax on Benefits

Benefits Taxation for Over-65 Social Security Recipients	No Taxation of Benefits	Some Inclusion of Benefits at 50% but not at 85%	Some Inclusion at 85%
1993 Social Security Study	81.8%	7.6%	10.6%
2004- Married Filing Jointly	50%	14.4%	35%
2004- Single	65%	9%	26%
2008- Married Filing Jointly	44%	21%	35%
2008- Single	82%	11%	7%

Because income levels for benefits taxation have remained unchanged since 1993, more married individuals now pay tax on at least some of their benefits than when benefits taxation was first introduced, although the percentage reaching the level for 85% inclusion is virtually unchanged.

Conversely, the percentage of over-65 taxpayers filing as single who pay no tax on benefits has returned to the level found in the original 1993 study. One indication that the benefits taxation of non-married persons aged 65

or older have declined is found in an examination of Table 9.A2 (SSA 2010). This examination reveals that the extent to which non-married persons rely on social security benefits for retirement income far exceeds that of married couples. More than 46% of non-married persons aged 65 or older rely on social security for at least 90% of their total retirement income- levels which result in no taxation of benefits- while only 22.5% of married couples in the same age group rely on social security benefits to that degree. Further, the number of non-married persons identified as being eighty years or older (5,940,000) is the largest of any age group of either married couples or unmarried persons. This group has the lowest level of income, relying on Social Security benefits far more than other age group; more than 50% of persons in this category rely on social security benefits for 90% of their total retirement income. Additionally, a comparison of the 2008 data to the same data available from 2004 indicates that the increase of 644,000 in the number of non-married persons aged 80 and older is the largest increase of any age category of either married couples or non-married persons. A further comparison of the 2008 data to the 2004 data reveals that, in general, non-married persons in every age group have increased their reliance on social security benefits over the years to a greater extent than married couples have. Because of this increase in lower income non-married persons and their increased reliance on social security benefits, their income from other sources is not large enough to require payment of taxes on social security benefits. As indicated above, the proportion of non-married recipients with benefits subject to taxation is therefore declining.

CONCLUSION

When taxation of social security benefits first began in the 1980's, the authors of the new tax legislation made a conscious decision to provide for the inclusion of benefits into taxable income using cut-off points that would not be adjusted for inflation or other factors. Over time, as incomes and benefits increased and the rest of the personal tax structure was modified through indexation, more and more social security benefits become subject to tax. Standard deduction amounts and personal exemption amounts for over-65 individuals are approaching the lower limits set for inclusion of benefits as part of taxable income. As we point out in our 2003 paper, once inclusion begins recipients are subject to effective increased marginal rates of taxation. Because of increased benefit amounts, inclusion occurs over a wider range of income, producing distortions in tax incentives for individuals in this range.

As part of the coming effort to insure the long-term viability of Social Security, the subject of benefits taxation is sure to once again become a major issue. Taxation of benefits produces a major addition to the trust fund. According to the 2010 Trustee's Report, almost $20 billion was deposited from taxation of benefits. As suggested in the initial proposals for the last two taxation changes, one alternative would be the elimination of the current system of caps in favor of treatment of social security income in the same way as the taxation of other types of annuities. Advantages of this change would be:

- Increased revenue production from benefits taxation
- Consistency of tax treatment with other types of annuity income
- Tax simplification
- Elimination of high effective marginal tax rates during inclusion

Any negative effect on low-income recipients could be offset by a standard deduction for the elderly that would eliminate taxation of low income recipients.

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