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# Social Security: Calculation and History of Taxing Benefits

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# Summary

Social Security provides monthly cash benefits to retired or disabled workers and their family members and to the family members of deceased workers. Those benefits were exempt from federal income tax, but in 1983, Congress approved recommendations from the National Commission on Social Security Reform (also known as the Greenspan Commission) to tax the benefits of some higher-income Social Security beneficiaries. Beginning in 1984, up to 50% of Social Security and Railroad Retirement Tier I benefits became taxable for individuals whose provisional income exceeds $25,000. The threshold is $32,000 for married couples. Provisional income equals adjusted gross income (total income from all sources recognized for tax purposes) plus certain otherwise tax-exempt income, including half of Social Security and Railroad Retirement Tier I benefits. The proceeds from taxing Social Security and Railroad Retirement Tier I benefits at up to 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, the Omnibus Budget Reconciliation Act (OBRA) increased the share of some Social Security and Railroad Retirement Tier I benefits that are taxable. That law 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 additional proceeds from that law are credited to the Medicare Hospital Insurance (HI) Trust Fund.

In 2016, the federal government received $51.8 billion in revenue from taxation of those benefits. Of that, $31.6 billion was credited to the Social Security trust funds, accounting for 3.4% of its total income. The remaining $20.2 billion was credited to the Medicare HI trust fund, which equaled 7.3% of its total income.

The Congressional Budget Office (CBO) projected that 49% of Social Security beneficiaries (25.5 million people) were affected by the income taxation of Social Security benefits in tax year 2014. That share will grow over time because the income thresholds used to determine the share of benefits that is taxable are not indexed for inflation or wage growth. As a result, income taxes on benefits will become an increasingly important source of income for Social Security and Medicare.

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The Social Security system provides monthly benefits to qualified retirees, disabled workers, and their spouses and dependents. Before 1984, Social Security benefits were exempt from the federal income tax. Congress then enacted legislation to tax a portion of those benefits, with the share gradually increasing 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 first tier and second tier.

# 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 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 adjusted gross 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), *plus* 50% of Social Security benefits.

The first tier thresholds, below which no Social Security 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. In the case of taxpayers who are married filing separately, the threshold is also $25,000 if the spouses lived apart all year, but it is $0 for those who lived together at any point during the tax year.

If provisional income is between the first tier thresholds and the second tier thresholds of $34,000 (for single filers) or $44,000 (for married couples filing jointly), the amount of Social Security benefits subject to tax is the lesser of (1) 50% of Social Security benefits or (2) 50% of provisional income in excess of the first threshold.

If provisional income is above the second tier threshold, the amount of Social Security benefits subject to tax is the lesser of (1) 85% of benefits or (2) 85% of provisional income above the second threshold, plus the smaller of (a) $4,500 (for single filers) or $6,000 (for married filers)[5] or (b) 50% of benefits.

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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 the retiree receives 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. See CRS Report RS22350, *Railroad Retirement Board: Retirement, Survivor, Disability, Unemployment, and Sickness Benefits*. In this report, references to Social Security benefits generally also apply to 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*, at http://www.irs.gov/pub/irs-pdf/p915.pdf.

[3] Adjusted gross income is the main measure of income used when computing income taxes. The Internal Revenue Service refers to provisional income as *modified adjusted gross* income. 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.

[5] The $4,500 and $6,000 amounts are the maximum taxes for the first tier calculation, and are equivalent to 50% of the (continued...)

Because the threshold for married taxpayers filing separately who have lived together any time during the tax year is $0, the taxable benefits in such a case are the lesser of 85% of Social Security 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 benefits.

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

| | Provisional Income[a] | Taxable Social Security and Tier I Railroad Retirement Benefits |
|---|---|---|
| | | **Single Taxpayer** |
| (A) | Less than $25,000 | None |
| (B) | $25,000 to $34,000 | Lesser of (1) 50% of benefits or (2) 50% of provisional income above $25,000 (maximum of $4,500) |
| (C) | Over $34,000 | Lesser of (1) 85% of benefits or (2) 85% of provisional income above $34,000 plus amount from line (B) |
| | | **Married Taxpayer** |
| (D) | Less than $32,000 | None |
| (E) | $32,000 to $44,000 | Lesser of (1) 50% of benefits or (2) 50% of provisional income above $32,000 (maximum of $6,000) |
| (F) | Over $44,000 | Lesser of (1) 85% of benefits or (2) 85% of provisional income above $44,000 plus amount in line (E) |

**Source:** Internal Revenue Service, Publication 915, "Social Security and Equivalent Railroad Retirement Benefits."

a. Provisional income is adjusted gross income plus certain income exclusions plus 50% of Social Security benefits.

The two examples in **Table 2** illustrate how taxable Security benefits may be calculated for a *single* retiree in tax year 2016. The retiree is at least 62 years of age and receives $15,000 in annual Social Security benefits—about the average for a retired worker.[6] The examples include other (non-Social Security) income of $20,000 or $30,000.

(...continued)

difference between the first and second tier thresholds.

[6] The average monthly Social Security payment for a retired worker in August 2016 was $1,305. This would be an annual payment amount of $15,660. Information on current monthly benefit payments is available in the Monthly Statistical Snapshot at http://www.ssa.gov/policy/docs/quickfacts/stat_snapshot/.

**Table 2. Example of Calculation of Taxable Social Security Benefits for Single Social Security Recipients with a $15,000 Benefit and Different Levels of Other Income**

| **Step 1: Calculate Provisional Income** | **John** | **Mary** |
|---|---|---|
| Other income | $20,000 | $30,000 |
| + 50% of Social Security (assume Social Security benefits are $15,000) | $7,500 | $7,500 |
| = Provisional income | $27,500 | $37,500 |
| **Step 2: Compare Provisional Income to First Tier Threshold** | | |
| *First tier threshold* | *$25,000* | *$25,000* |
| Excess over first tier threshold<br>Lesser of<br>• Provisional income *minus* first tier threshold *or*<br>• Difference between first and second tier thresholds [$9,000] | $2,500 | $9,000 |
| First tier taxable benefits equals<br>Lesser of<br>• 50% of benefits *or*<br>• 50% of excess over first tier | $1,250 | $4,500[a] |
| **Step 3: Compare Provisional Income To Second Tier Threshold** | | |
| *Second tier threshold* | *$34,000* | *$34,000* |
| Calculate excess over second tier<br>• Provisional income *minus* second tier threshold | $0 | $3,500 |
| Second tier taxable benefits<br>85% of excess | $0 | $2,975 |
| **Step 4: Calculate Total Taxable Social Security Benefits** | | |
| For John: Provisional income is less than $34,000, so total taxable benefits equal first tier taxable benefits.<br>For Mary: Provisional income is greater than $34,000, so total taxable benefits equal the lesser of<br>• 85% of Social Security benefits (= $12,750) *or*<br>• First tier taxable benefits *plus* second tier taxable benefits ($4,500 + $2,975 = $7,475) | $1,250 | $7,475 |

**Source:** Congressional Research Service (CRS).

a. The maximum amount of first tier taxable benefits is 50% of the difference between the second and first tier thresholds ($34,000 - $25,000 = $9,000 × 50% = $4,500).

The calculation of taxable Social Security benefits depends on the level of benefits and the level of non-Social Security income. Holding benefits constant, as non-Social Security income increases, provisional income increases, and therefore the amount of taxable Social Security benefits increases. Holding non-Social Security income constant, as Social Security benefits increase, the amount of Social Security benefits that is taxable increases. Those two perspectives are illustrated in the two figures below. (The figures are for single retirees only, but they would be similar for married couples.)

**Figure 1** shows taxable Social Security benefits for single retirees with four different amounts of annual Social Security benefits ($10,000, $15,000, $20,000, and $25,000) as non-Social Security income increases from zero to $45,000. (Provisional income, which equals non-Social Security income plus half of Social Security benefits, is not shown directly in the figure.) Once provisional income exceeds the first tier threshold of $25,000, each additional dollar of non-Social Security income results in 50 cents of additional taxable income. For example, for someone with Social Security benefits of $10,000, no benefits are taxable unless non-Social Security income exceeds $20,000, in which case provisional income would exceed $25,000 (which equals $20,000 plus half of $10,000).

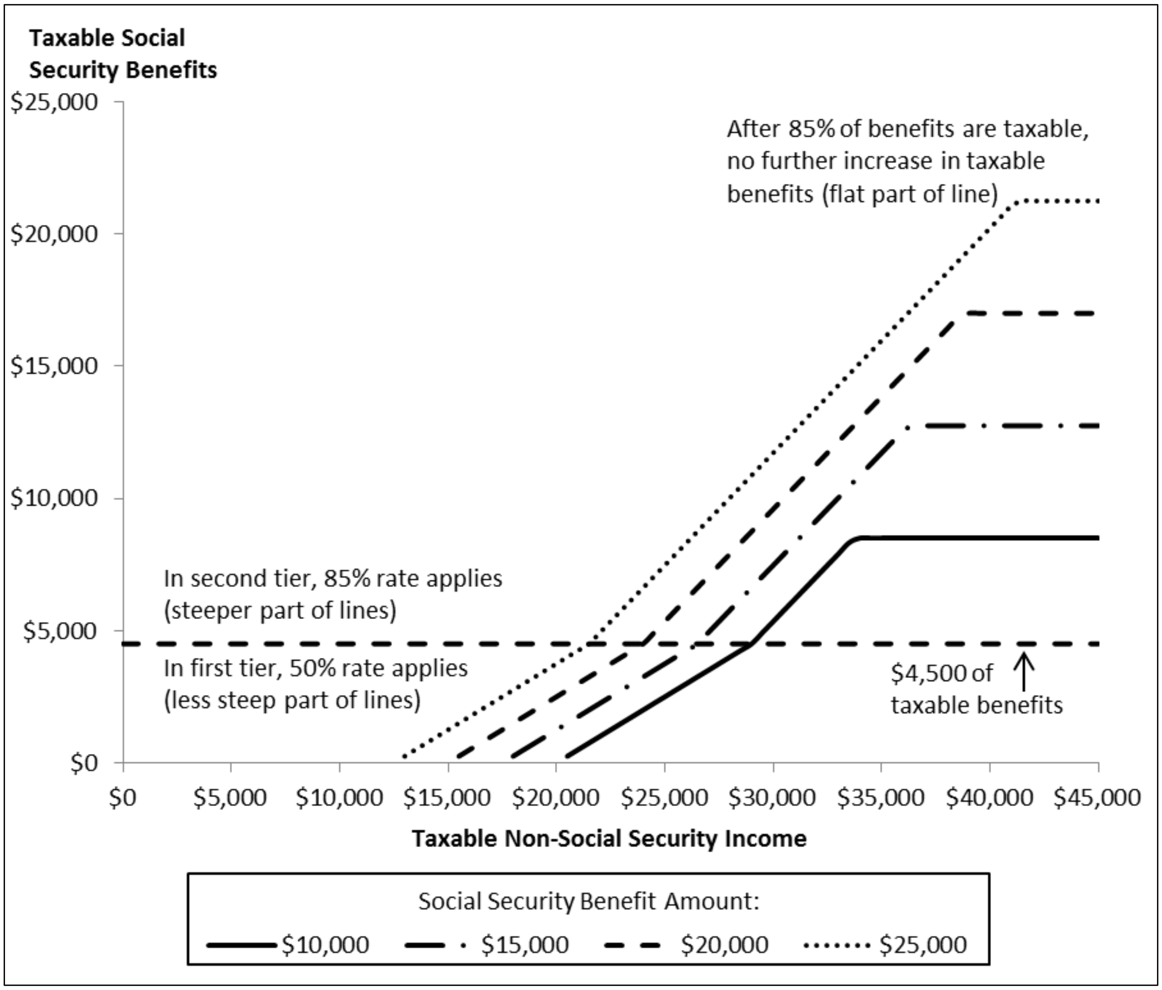
Once provisional income exceeds the second tier threshold, each additional dollar of non-Social Security income results in an additional 85 cents of taxable income. As described above, the second tier threshold occurs when provisional income exceeds $34,000, at which point taxable Social Security benefits exceed $4,500. In the figure, a horizontal line marks $4,500 of taxable Social Security benefits.

The amount of Social Security benefits that are taxable continues to increase as non-Social Security income increases until 85% of Social Security benefits are taxable. After that, the amount of taxable benefits is constant, as shown by the flat portions of the lines on the right-hand side of the figure.

Note that the additional *tax* owed is less than the additional *taxable income*. The additional tax owed equals the additional taxable income multiplied by the taxpayer's marginal tax rate.

**Figure 1. Taxable Social Security Benefits as Annual Non-Social Security Income Increases**

(for single retirees with four different amounts of annual Social Security benefits)




**Source:** Congressional Research Service (CRS).

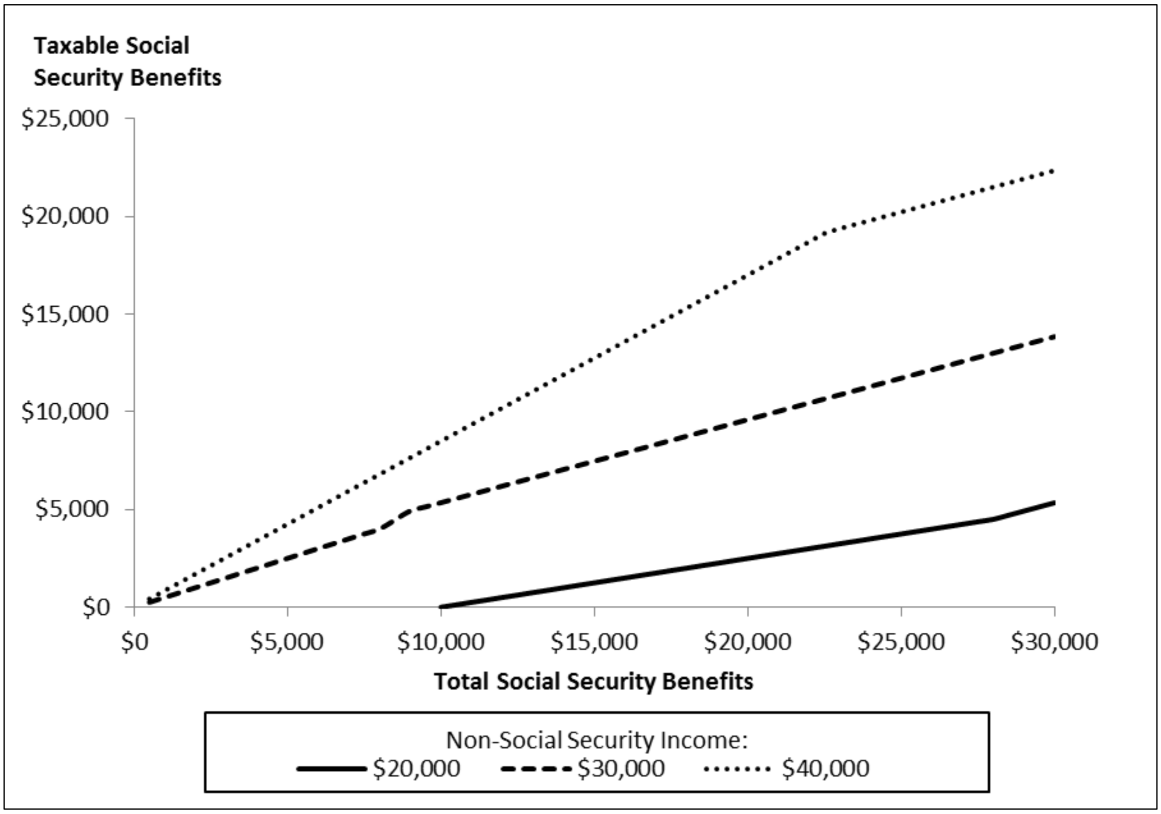
**Notes:** Once provisional income (taxable non-Social Security income plus half of Social Security benefits) exceeds the first tier threshold of $25,000, each additional dollar of non-Social Security income results in 50 cents of additional taxable income. Once provisional income exceeds the second tier threshold of $34,000, when taxable Social Security benefits equal $4,500, each additional dollar of non-Social Security income results in 85 cents of additional taxable income, reflected in the steeper lines.

**Figure 2** shows taxable Social Security benefits for single retirees with three different levels of non-Social Security income ($20,000, $30,000, and $40,000) as Social Security benefits increase. (Provisional income, which equals non-Social Security income plus half of Social Security benefits, is not shown directly in the figure.) For people with $10,000 of Social Security benefits, those benefits would be untaxed unless non-Social Security income exceeded $20,000, at which point provisional income would exceed the $25,000 threshold (which equals half of $10,000 plus $20,000).

As noted above, the additional *tax* owed is less than the additional *taxable income*, because the additional tax owed equals the additional taxable income multiplied by the taxpayer's marginal tax rate.

**Figure 2. Taxable Social Security Benefits as Total Annual Social Security Benefits Increase**

(for single retirees with three different amounts of annual non-Social Security income)




**Source:** CRS.

**Notes:** For any fixed amount of non-Social Security income, the amount of taxable Social Security benefits increases as total Social Security benefits increase. The slope of the lines vary because the amount of Social Security benefits that is taxable increases at varying rates as total benefits 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** and **Figure 2** do not reflect 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 nonresident 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 (45 U.S.C. §231m), 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.

As shown in **Table 3**, 30 states and the District of Columbia fully excluded Social Security benefits from the state personal income tax. Seven states tax all or part of Social Security benefits but differ from the federal government, and six states follow the federal government in their tax treatment of Social Security benefits. The remaining seven states have no personal income tax.

**Table 3. State Income Taxation of Social Security Benefits, Tax Year 2015**

| | |
|---|---|
| Thirty states and the District of Columbia exempt Social Security benefits from income taxation | Alabama, Arizona, Arkansas, California, Delaware, District of Columbia, Georgia, Hawaii, Idaho, Illinois, Indiana, Iowa, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Mississippi, New Hampshire, New Jersey, New York, North Carolina, Ohio, Oklahoma, Oregon, Pennsylvania, South Carolina, Tennessee, Virginia, Wisconsin |
| Seven states tax all or part of Social Security benefits but not the same as federal taxation | Colorado, Connecticut, Kansas, Missouri, Montana, Nebraska, Utah |
| Six states follow federal taxation of Social Security benefits | Minnesota, New Mexico, North Dakota, Rhode Island[a], Vermont, West Virginia |
| States without an income tax | Alaska, Florida, Nevada, South Dakota, Texas, Washington, Wyoming |

**Source:** Rick Olin, Wisconsin Legislative Fiscal Bureau, *Individual Tax Provisions in the States*, Informational Paper 4, January 2013, available at http://legis.wisconsin.gov/lfb/publications/Informational-Papers/Documents/2013/4_Individual%20Income%20Tax%20Provisions%20in%20the%20States.pdf, and 2014 Nebraska Individual Income Tax Booklet, at http://www.revenue.nebraska.gov/tax/14forms/f_1040n_booklet.pdf.

**Notes:** In 2014 and earlier, Nebraska followed federal taxation of Social Security benefits.

a. Tax years beginning on or after January 1, 2017, allow for a modification for up to $15,000 of taxable pension and/or annuity income that is included in federal Adjusted Gross Income. This means Rhode Island will change categories to "all or part of Social Security benefits but not the same as federal taxation" in 2017 (RIGL § 44-30-12).

# Taxation of Social Security Benefits by Income Level

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 increases over time. The Congressional Budget Office (CBO) projected that 49% of Social Security beneficiaries (25.5 million people) were affected by the income taxation of Social Security benefits in tax year 2014. That share has almost doubled since 1998, when 26% of beneficiaries were affected by taxation of benefits.[8]

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

[8] Congressional Budget Office, "Effect of Taxing Social Security Benefits by income Class Estimated for Tax Year 2014", https://www.cbo.gov/publication/49949. Estimates provided by CBO for other years were originally reported in the Green Book, Committee on Ways and Means, U.S. House of Representatives (1998, 2000, and 2008 editions). Changes from year to year may also reflect changes to CBO's methodology and data sources over time.

**Table 4** shows CBO's estimates for tax year 2014 of the number of Social Security beneficiaries and of the number and share of beneficiaries affected by the taxation of Social Security benefits, by level of income. The percentage of Social Security beneficiaries affected increases sharply with income.

**Table 4. Estimated Number and Percentage of Beneficiaries with Taxable Social Security Benefits by Income Class, 2014**

| Income Class | Number of Social Security Beneficiaries (millions) | Number of Beneficiaries Affected by Taxation (millions) | Percentage of Beneficiaries Affected by Taxation |
|---|---|---|---|
| Less than $10,000 | 3.5 | a | a |
| $10,000 - $15,000 | 4.6 | a | a |
| $15,000 - $20,000 | 4.4 | a | a |
| $20,000 - $25,000 | 3.3 | a | a |
| $25,000 - $30,000 | 3.0 | 0.1 | 2% |
| $30,000 - $40,000 | 5.6 | 1.5 | 26% |
| $40,000 - $50,000 | 4.5 | 2.6 | 57% |
| $50,000 - $100,000 | 14.6 | 13.4 | 92% |
| Over $100,000 | 8.0 | 7.9 | 99% |
| **Total** | **51.5** | **25.5** | **49%** |

**Source:** Congressional Budget Office, "Effect of Taxing Social Security Benefits by income Class Estimated for Tax Year 2014", https://www.cbo.gov/publication/49949.

**Notes:** Simulations based on Statistics of Income data from the Internal Revenue Service, supplemented by data from the Current Population Survey. Income is defined as adjusted gross income plus statutory adjustments, tax-exempt interest, and nontaxable Social Security benefits. Number of Social Security beneficiaries includes beneficiaries under and over the age of 65.

a. Less than 50,000 people or less than 0.5%.

**Table 5** shows how the share of benefits that are taxed increases with income.

**Table 5. Estimated Social Security Benefits and Taxes on Social Security Benefits by Income Class, 2014**

| Income Class | Social Security Benefits (billions) | Taxes on Social Security Benefits (billions) | Taxes as a Percentage of Benefits |
|---|---|---|---|
| Less than $10,000 | $26.0 | a | a |
| $10,000 - $15,000 | $53.6 | a | a |
| $15,000 - $20,000 | $64.0 | a | a |
| $20,000 - $25,000 | $48.2 | a | a |
| $25,000 - $30,000 | $43.6 | a | a |
| $30,000 - $40,000 | $84.7 | $0.4 | a |
| $40,000 - $50,000 | $71.1 | $1.5 | 2 |
| $50,000 - $100,000 | $234.1 | $20.6 | 9 |
| Over $100,000 | $137.3 | $28.8 | 21 |
| **Total** | **$762.5** | **$51.3** | **7%** |

**Source:** Congressional Budget Office, "Effect of Taxing Social Security Benefits by income Class Estimated for Tax Year 2014", https://www.cbo.gov/publication/49949.

**Notes:** Simulations based on Statistics of Income data from the Internal Revenue Service, supplemented by data from the Current Population Survey. Income is defined as adjusted gross income plus statutory adjustments, tax-exempt interest, and nontaxable Social Security benefits. Number of Social Security beneficiaries includes beneficiaries under and over the age of 65.

a. Less than $50 million or less than 0.5%.

# Impact on the Trust Funds

The proceeds from taxing Social Security and Railroad Retirement benefits at the 50% rate are credited to the Social Security's two trust funds—the Old-Age and Survivors Insurance (OASI) and Disability Insurance (DI) trust funds—and to the Railroad Retirement system, on the basis of the source of the benefits taxed. Proceeds from taxing benefits at higher rates are credited to Medicare's Hospital Insurance (HI) trust fund.

In 2016, the OASI and DI (collectively referred to as OASDI) trust funds were credited with $31.6 billion from taxation of benefits, or 3.4% of the funds' total income.[9] Income from the taxation of benefits in the HI fund in 2016 was $20.2 billion, or 7.3% of total HI fund income.[10]

Because the income thresholds used to determine the share of benefits that is taxable are not indexed for inflation or wage growth, income taxes on benefits will become an increasingly important source of tax revenues for Social Security and Medicare. Currently, about 35% of the total Social Security benefits are subject to income tax. CBO estimates that proportion will

[9] Social Security Administration, Trust Fund Financial Data, http://www.ssa.gov/OACT/ProgData/allOps.html. Of the $31.6 billion, $30.6 billion was credited to the OASI trust fund and $1.1 billion to the DI trust fund (totals do not necessarily equal the sums of rounded components).

[10] 2016 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds.

increase to over 50% by 2046.[11] The income taxes collected from Social Security benefits are projected to grow from 0.2% of GDP in 2016 to 0.3% of GDP in 2046.[12]

Under the intermediate assumptions, the Social Security and Medicare trustees project that over the next 30 years, income taxes will grow from 4% of Social Security's tax revenue (i.e., non-interest income) to 6.5%. Additionally, the share will continue to grow, to over 7% by 2095.[13] For Medicare, income tax on benefits as a share of total tax revenue (non-interest income) increases from just over 3% to around 4.7% in 2040 and later.[14] Revenue from benefit taxes will be a smaller share of total Medicare program revenues, because in addition to tax revenue, it receives interest on trust fund balances (as does OASDI), and Medicare receives income from premiums and from general revenue.

# 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 Social Security 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.[15]

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 (AFDC), Supplemental Security Income (SSI), and benefits under the Black Lung Benefits Act). 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.[16] Benefits from those 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 half 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 contributions to the system are not considered part of the employee's gross income, and are

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[11] Congressional Budget Office, *The 2016 Long-Term Budget Outlook*, July 2016, p. 60, at http://www.cbo.gov/sites/default/files/114th-congress-2015-2016/reports/51580-LTBO.pdf.

[12] Ibid, p. 27.

[13] Social Security Administration, Office of the Chief Actuary, "Components of Annual Income Rates—Consistent with 2016 OASDI Trustees Report," at https://www.ssa.gov/oact/tr/2016/lr4b2.html.

[14] Center for Medicare and Medicaid Services, Office of the Actuary, "Medicare Sources of Income as a Percentage of Total Income," in 2014 Expanded and Supplementary Tables to the 2014 Medicare Trustees Report, at http://www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/ReportsTrustFunds/index.html.

[15] U.S. Congress, Senate Committee on Finance, *Tax Free Status of Social Security Benefits,* report to accompany S.Res. 87, S.Rept. 97-135, June 15, 1981.

[16] Most federal civilian employees hired before 1984 are covered by CSRS; those hired later are covered by the Federal Employees' Retirement System (FERS). See CRS Report 98-810, *Federal Employees' Retirement System: Benefits and Financing*.

deductible from the employer's business income as a business expense. Consequently, neither the employee nor the employer pays taxes on the employer's contribution.[17]

The 1979 Advisory Council on Social Security concluded that because Social Security benefits are based on earnings in covered employment, 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.[18] 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 and to avoid "taxing more of the benefit than most people would consider appropriate," 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.[19] 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 that, beginning in 1984, 50% of Social Security cash benefits and Railroad Retirement Tier I benefits be taxable for individuals whose adjusted gross income, excluding Social Security benefits, exceeded $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.[20] The commission did not include any provisions for indexing the thresholds. The commission estimated that 10% of Social Security beneficiaries would be subject to taxation of benefits. The commission acknowledged that the proposal had a "notch" problem, in that people with income at the thresholds would pay significantly higher taxes than those with only one dollar less, 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 that gradually increased the taxable share as a person's income rose above the thresholds, up to a maximum of 50% of benefits. The formula calculated taxable benefits as the lesser of 50% of benefits or 50% of the excess of the taxpayer's provisional income over thresholds of $25,000 (for single filers) and $32,000 (for married filers). Provisional income equaled adjusted gross income plus tax-exempt interest plus certain income exclusions plus 50% of Social Security benefits.

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

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[17] Under the Self-Employment Contributions Act (SECA), self-employed workers pay the full 12.4% payroll tax, but to ensure parity with FICA, half of those payments are exempt from income tax.

[18] U.S. Congress, Senate, 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*, report. no. 96-230, March 11 and 13, 1980, p. 13.

[19] Social Security Administration, *Social security financing and benefits*, Report of the 1979 Advisory Council, 1981, pp. 64-65.

[20] 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.

expected benefits for current recipients (in 1993) would be approximately 4% or 5%. The actuarial estimates were that for workers just entering the workforce, the ratio would be, on average, about 7%.[21] 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 the difficulty of calculating the ratio of contributions to benefits for each individual when 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 (for single filers) and $32,000 (for married filers) were to pay taxes on their benefits. Also as under then-current law, the first step was to add 50%, not 85%, of benefits to adjusted gross 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 estimated 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. 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 (for single filers) and $40,000 (for married filers). 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 (for single filers) and $44,000 (for married filers). President Clinton signed the measure into law (as part of P.L. 103-66) on August 10, 1993. Although other changes in tax law have since affected the amount of taxes paid on Social Security benefits, there have been no direct legislative changes regarding taxation of Social Security benefits since 1993.

[21] Unpublished memo from Steve Goss, Social Security Office of the Actuary, November 19, 1993. The ratios were computed using nominal dollar values for both taxes and benefits.

# Appendix. Taxation of Benefits Under Special Situations

## Lump Sum Distributions

A Social Security beneficiary may receive a lump sum distribution of benefits owed for one or more prior years.[22] In this situation, a beneficiary may choose between two methods for calculating the taxable portion of the lump-sum distribution: (1) include all of the benefits for prior years in calculating the taxable benefits for the current year or (2) 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 either case, the additional taxable benefits are included in taxable income for the current year. In computing the taxable portion of benefits in prior years, some income sources generally excluded from the provisional income calculation are included.[23]

## 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—even if the repayment is for a benefit received in a previous year. For married taxpayers filing a joint return, net benefits equal the sum of the couple's Social Security gross benefits less the repayment.

If, however, the repayment results in negative net Social Security benefits, there are two consequences: (1) there are no taxable benefits and (2) the taxpayer may take a miscellaneous deduction as part of itemized deductions or a credit for the negative net Social Security benefits.[24]

## Coordination of Workers' Compensation

For individuals under the full retirement age, Social Security benefits are reduced by a portion of any workers' compensation payments (or payments from some other public disability program) received by the individual. Workers' compensation is generally not taxable. Any reduction in Social Security benefits due to the receipt of workers' compensation is still considered to be a Social Security benefit, however, so income taxes are computed based on the full (unreduced) benefit amount.[25]

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[22] 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). See Internal Revenue Service, *Publication 915*, "Lump-Sum Election." This is not the lump-sum death benefit, which is not subject to federal income tax.

[23] See "Lump-Sum Election" in Internal Revenue Service, *Publication 915.*

[24] 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. For details on the repayment computations, see Internal Revenue Service, *Publication 915*, "Repayments More Than Gross Benefits."

[25] Section 86(d)(3) of the Internal Revenue Code; see also United States Tax Court, T.C. Memo. 2012-249, August 28, 2012, at http://www.ustaxcourt.gov/InOpHistoric/moorermemo.TCM.WPD.pdf, and United States Tax Court, T.C. Summary Opinion 2014-66, July 10, 2014, at https://www.ustaxcourt.gov/InOpHistoric/EnglishSummary.Gerber.SUM.WPD.pdf.

## Treatment of Nonresident Aliens

Citizenship is not required for receipt of Social Security benefits. Nonresident aliens, under IRS definitions, may receive benefits provided they have engaged in covered employment and otherwise meet eligibility requirements. The IRS defines a nonresident alien as a noncitizen who (1) is not a lawful permanent resident (this is known as the Green Card Test) and (2) has been physically present in the United States for fewer than 31 days in the previous calendar year and 183 days in the previous three-year period, counting all the days in the calendar year and a portion of the days in the two previous calendar years (this is known as the Substantial Presence Test).[26] In general, 85% of the Social Security benefits for nonresident aliens is taxable (i.e., none of the thresholds apply) at a 30% rate. 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.[27]

### 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 taxpayers, 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.[28] Voluntary tax withholding became effective with payments issued in February 1999.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA; 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%). The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) extended the EGTRRA provisions to tax year 2012. The American Taxpayer Relief Act of 2012 (ATRA; P.L. 112-240) made the EGTRRA provisions permanent.

Nonresident aliens residing outside the United States are subject to different tax withholding rules. Section 871 of the Internal Revenue Code imposes a 30% tax withholding rate 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.

[26] See Internal Revenue Service, *Publication 915*, "Nonresident aliens," for a detailed definition of nonresident alien, including a definition of presence.

[27] See Internal Revenue Service, "TABLE 1. Withholding Tax Rates on Income Other Than Personal Service Income Under Chapter 3, Internal Revenue Code, and Income Tax Treaties" for a list of the countries whose citizens (as nonresident aliens) are exempt from U.S. income taxes on Social Security benefits, and countries where residing U.S. citizens are exempt, https://www.irs.gov/PUP/individuals/international/Tax_Treaty_Table_1.pdf.

[28] 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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