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Reducing the Social Security Benefits Tax

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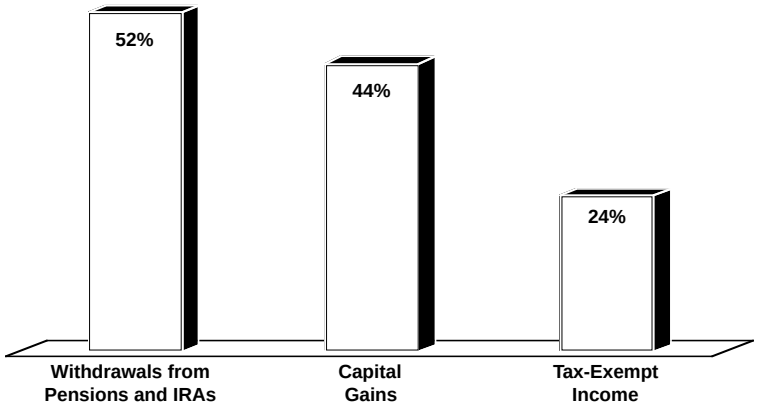
Since 1993, middle- and upper-income Social Security recipients have been subject to income tax on up to 85 percent of their benefits. On July 27, the House of Representatives voted to repeal this provision, leaving up to 50 percent of benefits still subject to taxation. The tax reduction would total $117.4 billion over 10 years. The vote was 265-159, with 213 Republicans and 52 Democrats in favor—a margin not large enough to override a presidential veto. The Senate must now consider the bill.

Repeal of this portion of the tax on Social Security is an important step because the peculiar method employed to tax Social Security benefits imposes some of the highest and most destructive marginal tax rates in the entire tax code. Ideally, the rest of the tax on Social Security benefits would be replaced with less destructive tax treatment, too.

FIGURE I

Marginal Tax Rates for the Middle Income Elderly
(28% federal income tax bracket)



Assumes couples receiving Social Security benefits with income of more than $44,000.

How Benefits Are Taxed. Social Security benefits were not subject to tax prior to the 1983 Social Security Amendments, which imposed taxes on up to half of benefits for single retirees with "modified adjusted gross income" over $25,000 and for couples with income over $32,000. (Modified adjusted gross income includes all ordinary adjusted gross income, plus half of Social Security benefits, plus income from tax-exempt bonds.) Affected retirees must add 50 cents in benefits to taxable income for every dollar by which their income exceeds these thresholds until half of their benefits become subject to tax. The revenues from this tier of tax are dedicated to the Social Security retirement trust fund.

The tax section of the Omnibus Budget Reconciliation Act of 1993 added a second tier of tax. Single retirees with income above $34,000 and couples with income over $44,000 have to add 85 cents in benefits to taxable income for every dollar of income above these thresholds until 85 percent of their benefits become subject to tax. It is this added layer of tax on benefits, passed by the Senate when Vice President Gore cast the tie-breaking vote, that the House voted to repeal. The revenue from this tier is dedicated to the Medicare trust fund. The bill would replace the money lost to the Medicare trust fund by crediting it with an equal amount of other tax revenue, in effect using some future general revenues to pay a portion of Medicare outlays.

When first imposed, taxation of Social Security benefits affected less than 10 percent of beneficiaries. Today, however, it affects about 22 percent of recipients, and it will affect many more people in the future, because the tax thresholds are not adjusted for inflation. By the time the children of the baby boomers retire, almost all beneficiaries will be paying tax on some portion of their benefits.

Taxing Non-Social Security Income. Despite its name, the Social Security benefits tax is not a tax on the benefits, but rather a tax on *other* retirement income. No tax is paid until the other income reaches a certain level. Above that threshold:

- The first tier of tax means that earning an extra dollar of interest, dividends or wages boosts taxable income by $1.50.

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- If the retiree is in the 28 percent tax bracket, his or her income tax rises by 42 cents — in effect a 42 percent tax rate on the added dollar of interest or dividends.

In the case of tax-exempt bond income, the added dollar of interest is not subject to tax, but it can make 50 cents of benefits taxable, triggering a tax of 14 cents in the 28 percent tax bracket. This in effect makes the tax-exempt bond income taxable at half the normal tax rate.

For retirees with income over the second threshold, as Figure I shows:

- Each added dollar of income from savings raises taxable income by $1.85.
- If the retiree is in the 28 percent tax bracket, his or her income tax rises by 52 cents, an effective marginal tax rate of 52 percent.

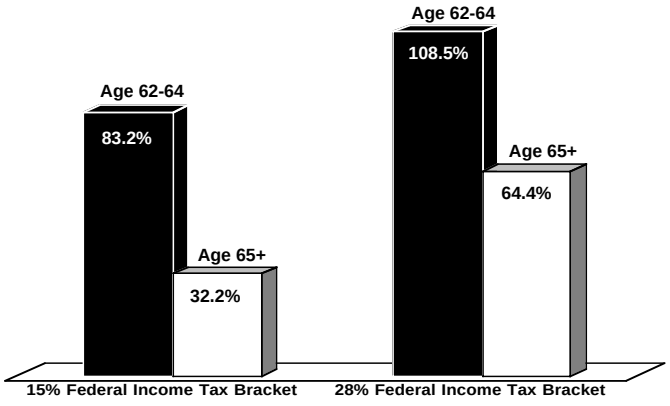
A dollar of tax-exempt interest triggers a tax of 24 cents on 85 cents of benefits, an effective tax rate of 24 percent on the supposedly tax-exempt earnings. A dollar of capital gains is taxed at 44 percent.

Penalizing Wage Income. If a Social Security beneficiary's added income is wage income, it is also subject to a 15.3 percent payroll tax, half on the employee and half on the employer. The employer receives a tax deduction for its half, reducing the effective payroll tax rate to 12.6 percent. For a couple age 65 or over in the 28 percent income tax bracket, adding the payroll tax and the Social Security benefits tax can push their marginal tax rate to as high as 64 percent.

Even worse, if a beneficiary is subject to the Social Security earnings test, the added tax can be greater than the added wages — a tax rate exceeding 100 percent! As Figure II shows, with the earnings penalty even beneficiaries in the 15 percent income tax bracket can face a marginal tax rate of 83 percent, exclusive of state tax.

FIGURE II

Marginal Tax Rates on Wages



Assumes couples receiving Social Security benefits age 62-64 subject to earnings penalty. Includes 15.3 percent FICA tax (half paid by employer) adjusted for employer's tax deduction. Does not include state income tax.

Although the earnings penalty for beneficiaries past the normal Social Security retirement age (65 for those born before 1938) has been repealed, a heavy penalty remains in effect for retirees who choose to collect reduced Social Security benefits before they reach the normal Social Security retirement age. A beneficiary in this age range with wage or salary income over a limited exempt amount ($10,080 in 2000) loses $1 in benefits for every $2 in earnings over the exempt amount. This is equivalent to a 50 percent marginal tax rate.

For a person in this situation, the loss of some Social Security benefits affects the amount of income used to determine how much of the remaining benefits are taxable. The complicated result is that the earnings test, the taxation of benefits at an above-normal marginal tax rate and the payroll tax combined can amount to a total federal tax increase of nearly $1.10 — perhaps $1.15 after state income taxes — on one added dollar of wages. These tax rates in excess of 100 percent are a virtual federal edict that older workers should drop out of the labor force.

Conclusion. These tax penalties on earning additional retirement income discourage people of all ages from saving for retirement and discourage older citizens from working. Working enables seniors to earn needed income, and the effort of these most experienced and productive workers boosts the economy.

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