ELDERLY TAXPAYERS
AND
THE CAPITAL GAINS TAX DEBATE

by

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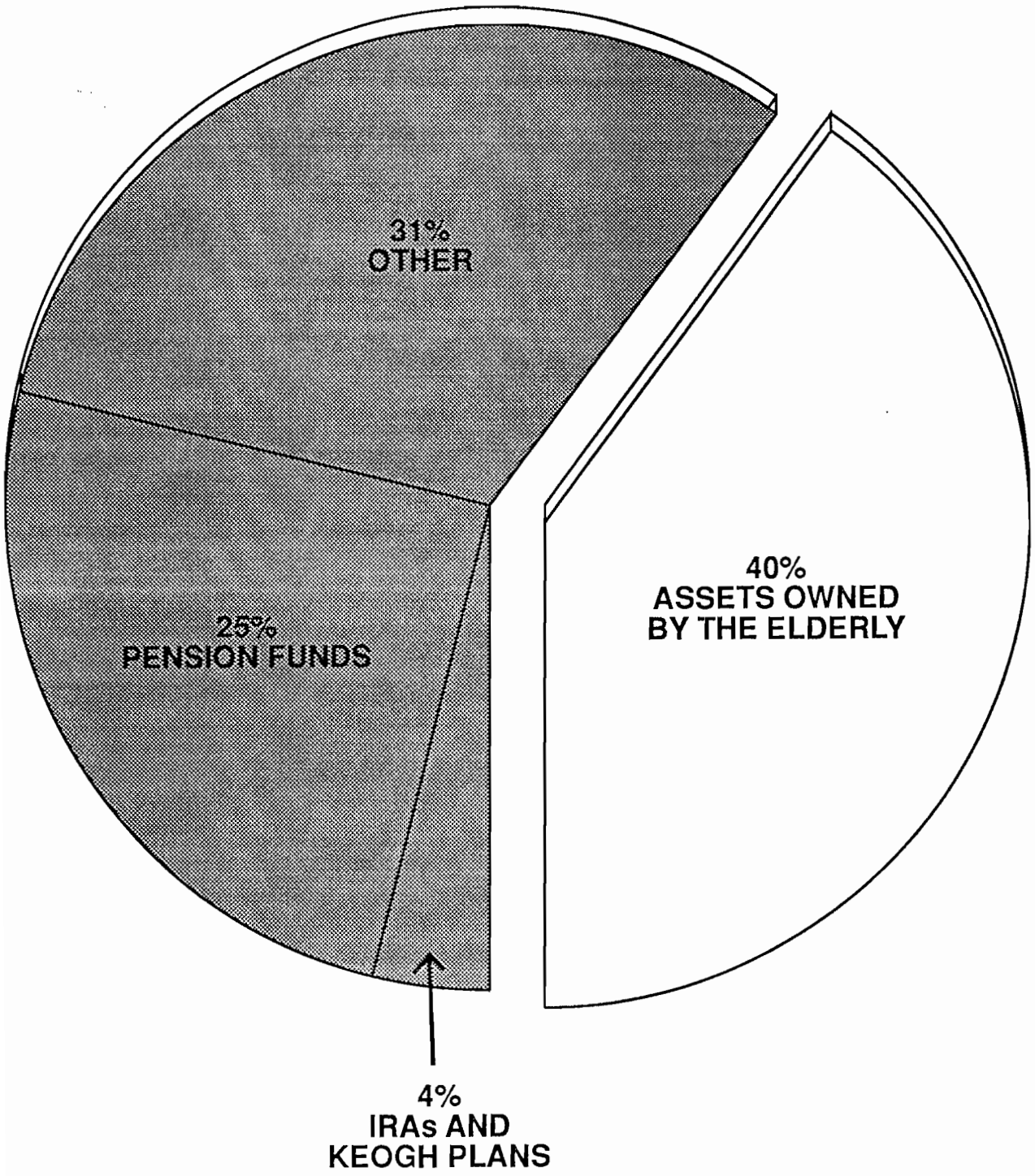
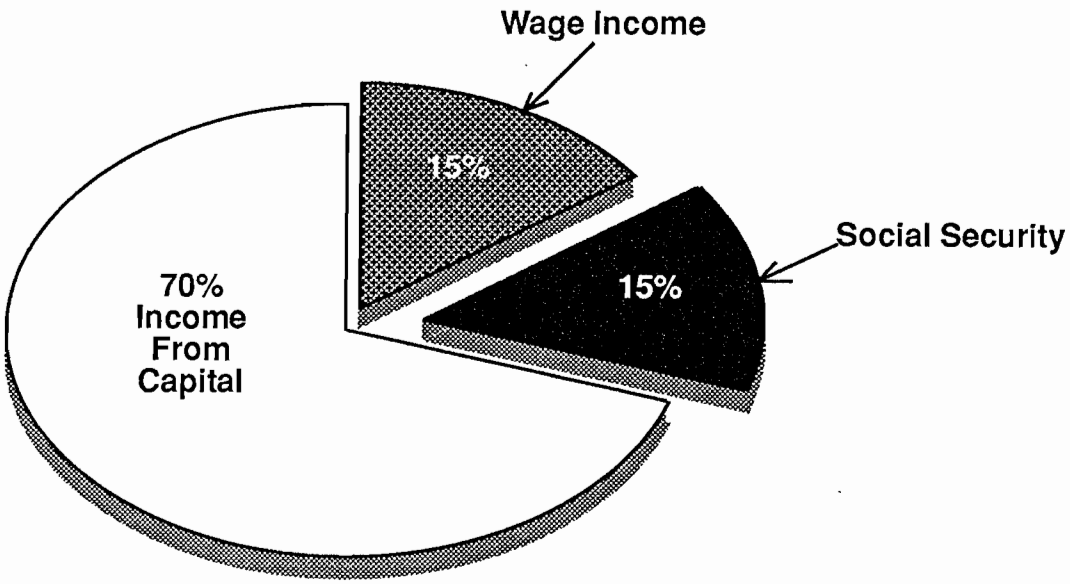
OWNERSHIP OF U.S. CAPITAL ASSETS

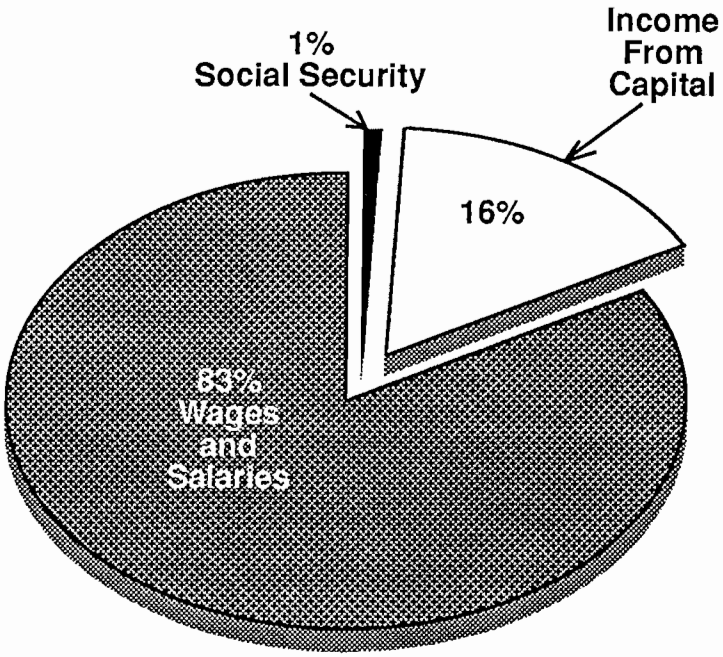


DISTRIBUTION OF TAXPAYER INCOME

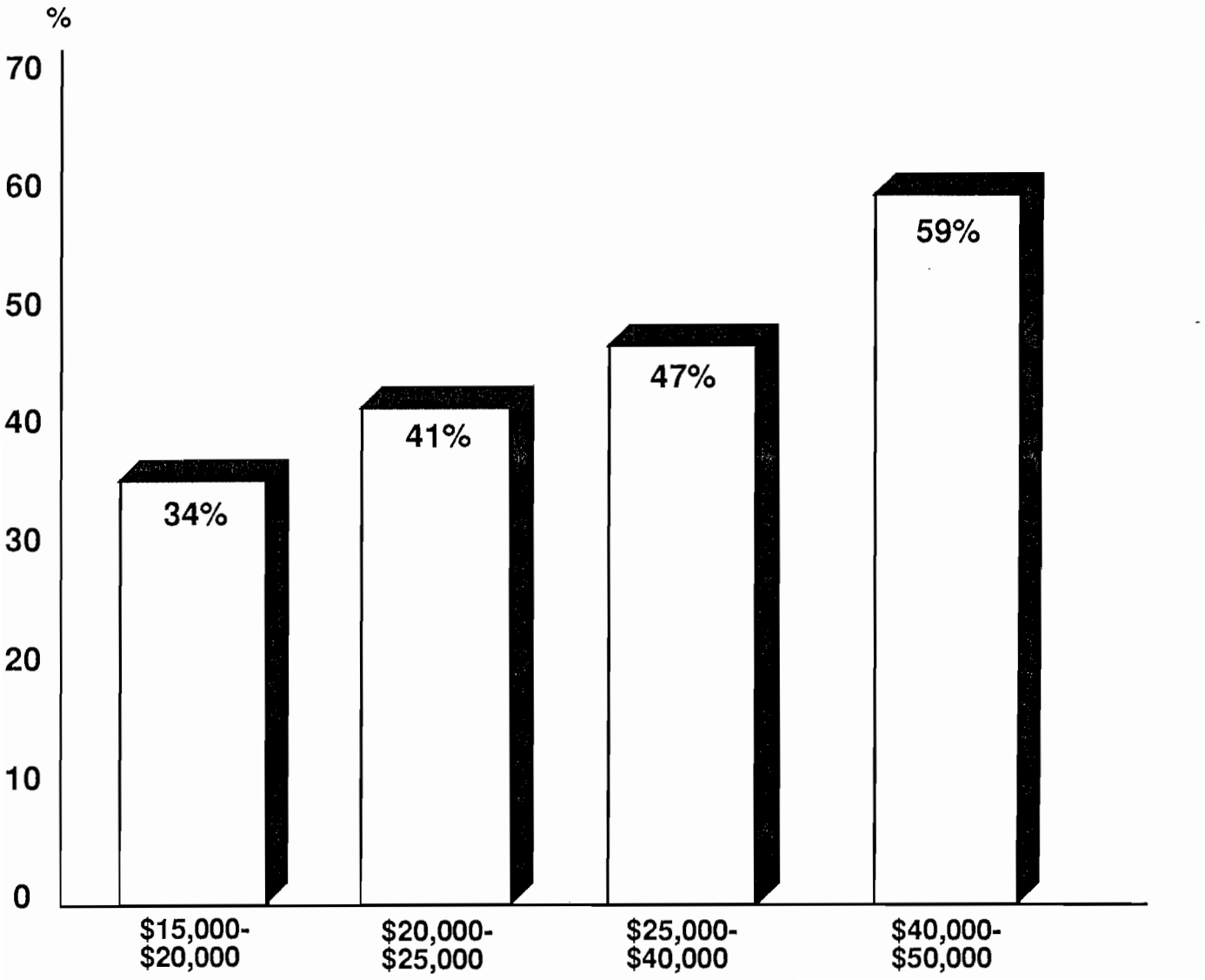
ELDERLY



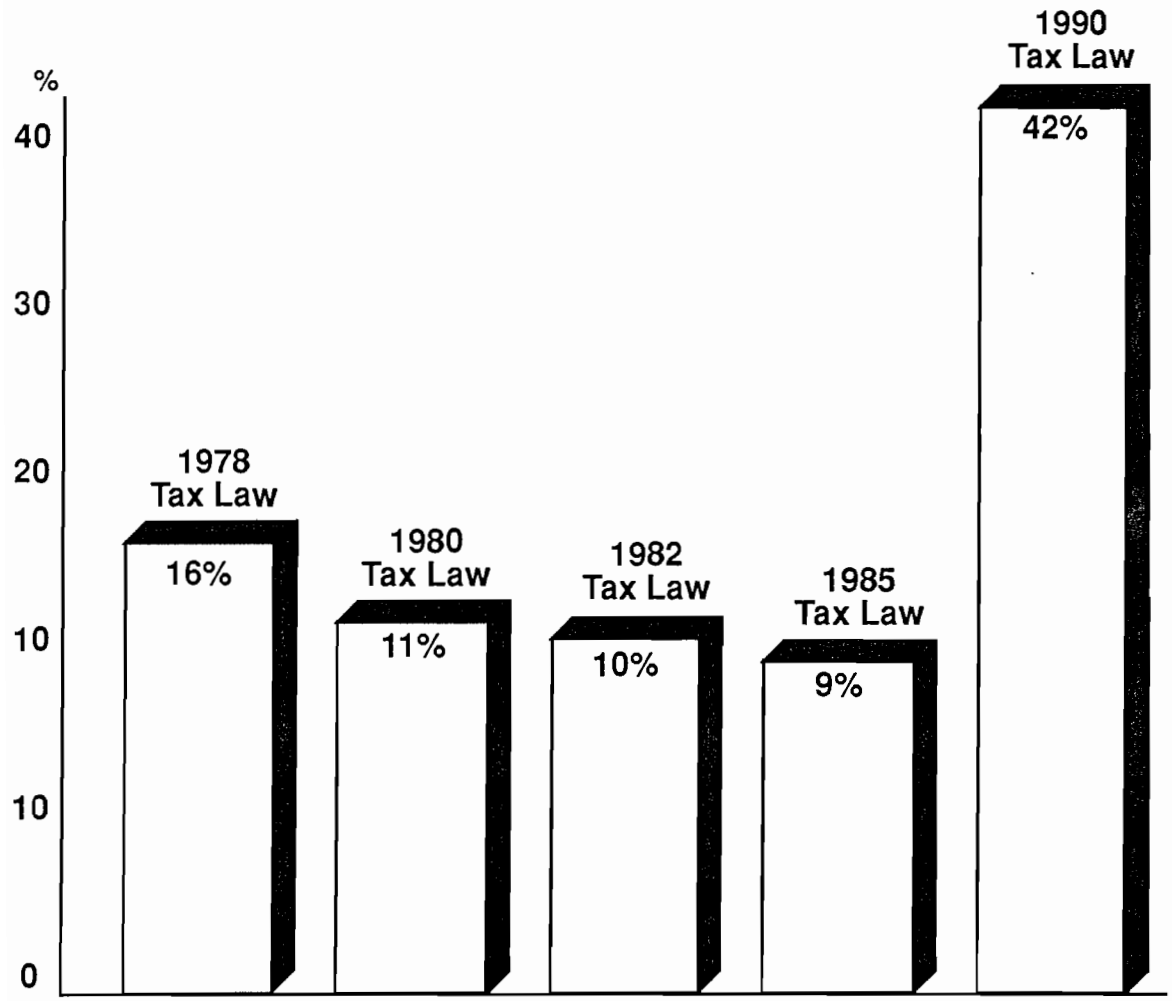
NONELDERLY



PERCENT OF MIDDLE-INCOME ELDERLY TAXPAYERS WHO HAVE A CAPITAL GAIN EACH YEAR



MARGINAL CAPITAL GAINS TAX RATE ON A MIDDLE-INCOME ELDERLY COUPLE



Note: Assumes each prior tax law is still in effect in 1990. Couple has a capital gain of $20,000. Social Security benefits equal $13,000. Other income equals $17,500.

EXECUTIVE SUMMARY

Income from the sale of assets is a more important source of income for people age 65 and over than for any other group of U.S. taxpayers.

- In any given year, almost one-third of elderly taxpayers have a capital gain.
- On the average, capital gains for elderly taxpayers are almost three times as large as for nonelderly taxpayers with the same total income.

These differences between elderly and nonelderly taxpayers do not arise because of the behavior of the wealthy. Instead, the most striking differences occur among middle-income families.

- Among people with an annual income between $25,000 and $40,000, almost half of elderly families have a capital gain each year compared with less than 10 percent of younger families.
- Among these middle-income groups, the capital gains income of the elderly is four to five times as great as it is for nonelderly families.

The importance of capital gains to the elderly reflects the fact that they are far more dependent than the nonelderly on income from investments. Overall:

- The elderly today hold 40 percent of all the capital assets in the United States.
- They receive about 53 percent of all interest income, 52 percent of all dividend income and more than 30 percent of all income from the sale of assets.
- Among elderly taxpayers, 70 percent of income is derived from investments (including private pensions), and only 15 percent is from wages.

Despite the fact that income from capital is so important to the economic well-being of the elderly, current federal policy discriminates against the elderly in two important ways:

- Because of the Social Security benefit tax, middle-income elderly families now face a tax rate on investment income that can reach as high as 42 percent, although younger taxpayers face a maximum rate of 28 percent.
- Although the federal tax code is indexed for inflation to protect wage income (the primary source of income for the young), there is no inflation protection for capital gains or other investments.

In order to correct the unfairness in the present tax code and encourage a higher national saving rate, we should index capital gains and other investment income for the effects of inflation, exempt capital gains and other investment income from the Social Security benefit tax, and lower the tax rate for capital gains on the sale of income-producing assets.

INTRODUCTION

Federal income tax treatment of income from capital should be of interest to all Americans. But the issue is especially important to elderly taxpayers.

- Although the elderly constitute only 12 percent of the population, they hold about 40 percent of all the capital assets in the United States.[1]

- As Table I shows, the elderly receive about 53 percent of all interest income, 52 percent of all dividend income, 30 percent of all capital gains income, and 32 percent of the income from all other sales of assets.[2]

In addition to the capital accumulation of the elderly, much capital accumulation by young people takes place for the express *purpose* of generating income during the years of retirement. For example:

- About 25 percent of the nation's capital is held in pension funds,[3] and another 4 percent in Individual Retirement Accounts (IRAs) and Keogh plans.[4]

- As a result, about 69 percent of our capital stock is either owned by the elderly or is being held for the specific benefit of future retirees.

Saving for retirement, and the resultant accumulation of capital, is important for two reasons. First, the driving force behind the American economy is its ability to combine labor with larger and larger amounts of capital. More capital per worker leads to more output per worker. These productivity gains result in higher wages and a higher standard of living for all Americans. Second, the willingness of Americans to save for retirement means that elderly retirees are much less dependent on the younger population than they otherwise would be. As Tables II and III show:

- Among elderly taxpayers, only 15 percent of income is in the form of Social Security benefits.[5]

- Fully 70 percent of the income of the elderly is from investments (including private pensions).

The ability of the U.S. to stimulate personal saving, however, depends crucially on the ability of retired people to reap the rewards of having saved. To the degree that government confiscates income from savings, the incentive to save is reduced for everyone — old and young.

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[1]See Aldona Robbins and Gary Robbins, "Taxing the Savings of Elderly Americans," National Center for Policy Analysis, NCPA Policy Report No. 141, September 1989, Appendix B.

[2]Refers to the sale of assets held for less than one year.

[3]Employee Benefit Research Institute, *Employee Benefit Notes*, Vol. 10, No. 4, July 1989, p. 5.

[4]Employee Benefit Research Institute, *Employee Benefit Notes*, Vol. 10, No. 7, July 1989, p. 5.

[5]About 58 percent of the elderly file income tax returns. Moreover, the amount of Social Security income shown in Tables II and III may be understated because many low-income taxpayers do not report Social Security benefits on their income tax returns. For middle- and higher-income families, Social Security benefits are now taxable.

TABLE I

SHARE OF INVESTMENT INCOME GOING TO ELDERLY TAXPAYERS[1]

Type of Income	Share Received by the Elderly[2]
Interest	52.7%
Dividends	52.0%
Capital Gains	29.9%
Other gains	31.8%

[1]Refers only to people filing tax returns. Figures are for 1985.

[2]At least one person on the tax return is age 65 or older.

Source: See Aldona Robbins and Gary Robbins, "Taxing the Savings of Elderly Americans," National Center for Policy Analysis, NCPA Policy Report No. 141, September 1989, Appendix B.

TABLE II

AVERAGE INCOME OF TAXPAYERS[1]

Source of Income	Elderly[2]	Nonelderly
Wages and Salaries	$4,727	$21,864
Social Security Benefits[3]	4,622	122[4]
Pensions	4,694	521
Interest	6,952	861
Dividends	2,317	351
Capital Gains[5]	7,266	2,459
Other Capital Income	1,287	21
Total[6]	$31,865	$26,199

[1]Refers only to people filing tax returns for 1986, the latest year for which statistics at this level of detail are available. Note: About 38 percent of elderly families and 5 percent of nonelderly families do not file tax returns. See U.S. Department of the Treasury, *Financing Health and Long-Term Care: Report to the President and Congress,* Washington, DC, March 1990, Table 4.1.

[2]At least one person on the tax return is age 65 or older.

[3]All Social Security benefits reported, including untaxed benefits. Note: The reported figure is below the actual number because most low-income taxpayers do not report this item.

[4]Includes early retirees, ages 62 to 64.

[5]Includes the portion of capital gains income excluded on 1986 tax returns.

[6]May not add exactly due to rounding. Totals show income prior to adjustments. The average adjustment is -$8,425 on elderly tax returns and -$2,024 on nonelderly returns.

Source: Estimates based upon tax return data. See Internal Revenue Service, *Statistics of Income — 1986, Individual Income Tax Returns*, Washington, DC, U.S. Government Printing Office, 1988, Table 2.5.

TABLE III

DISTRIBUTION OF AVERAGE INCOME OF TAXPAYERS

Source of Income:	Elderly	Nonelderly
Wages and Salaries	15%	83%
Social Security Benefits	15%	1%
Pensions	15%	2%
Interest	22%	3%
Dividends	7%	1%
Capital Gains	23%	9%
Other Capital Income	4%	0%
Total[1]	100%	100%

[1]May not add exactly due to rounding.

Source: Table II.

WHY THE CURRENT CAPITAL GAINS TAX IS UNFAIR

A capital gain is the difference between the sale price and the original purchase price of an asset. Under current law,[6] capital gains are taxed at the same rate as ordinary income.[7] This tax applies not only to the sale of stocks, bonds and real estate. It also applies to the sale of coin and stamp collections, paintings and antiques — objects which may have risen in value over time solely because of the effects of inflation.

Almost everyone who has thought seriously about the taxation of capital gains agrees that there is a problem with the current system. Calls for reform run the gamut — from the *Wall Street Journal* to the *New York Times,* from conservative economist Milton Friedman to liberal economist Alan Blinder. The only differences among serious students of the economics of taxation are differences over which method of reform should be adopted. And these are often differences over what is thought to be politically possible.

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[6]Current capital gains tax rates were established by the Tax Reform Act of 1986.

[7]The law limits the maximum tax rate on capital gains to 28 percent, even though some taxpayers pay an effective marginal rate of 33 percent on ordinary income. See *Internal Revenue Code* Sec. 1 (j).

Under the current system, any capital gain realized by an investor is taxed at the same rate — regardless of the type of asset, regardless of how long the asset has been held and regardless of the rate of inflation. To see why this method of taxation is troublesome, consider the effects of inflation:

- Since 1971, the price level in the United States has roughly tripled.
- Thus an asset purchased in 1971 for $1,000 and sold today for $3,000 would leave its owner no better or worse off in real terms.
- Yet under current law, an elderly investor could owe as much as $840 ($2,000 x 42%) in taxes, despite the fact there has been no *real* profit.

Because of inflation indexing, our tax code protects wage earners against being pushed into a higher tax bracket by the effects of inflation alone. But there is no similar protection from inflation-induced increases in the price of assets held for several years. As a result, our tax law discourages people from holding assets and thus discourages investment which is essential for economic growth.

An additional problem occurs with an income-producing asset, when the current value of the asset is determined by the future income it is expected to produce. Since the future income generated by the asset will eventually be realized and taxed, taxing the profit from the sale of the asset today is a form of double taxation. This problem will be considered in greater detail below.

TABLE IV

HOW INFLATION AFFECTS CAPITAL GAINS TAXES

	Historical Prices	Real Prices[1]
Asset Sale in 1990	$3,000	$3,000
Asset Purchase in 1971	$1,000	$3,000
Profit	$2,000	0
Taxable Gain Under Current Law	$2,000	

[1]Expressed in 1990 prices.

SPECIAL BURDEN FOR THE ELDERLY: HIGHER TAX RATES

Ronald Reagan's most important economic legacy was the lowering of marginal tax rates on income. In 1980 taxpayers faced a marginal tax rate as high as 70 percent. Today nonelderly taxpayers face a top marginal tax rate of 33 percent — a reduction of 37 percentage points. The picture is very different for elderly taxpayers, however.

The Social Security Benefit Tax. Under current law, one-half of Social Security benefits potentially are subject to federal income tax. The law applies only if one-half of Social Security income plus all non-Social Security income, including income from tax-exempt bonds, exceeds $25,000 for an individual or $32,000 for a couple. For taxpayers whose incomes exceed these thresholds, 50 cents of Social Security benefits is taxed for each dollar of additional income.[8] Although the Social Security benefit tax appears to be a tax on benefits, it is actually a tax on income:[9]

- Taxpayers who receive an additional $1 of income pay taxes on $1.50.
- This means that taxpayers in the 15 percent income tax bracket automatically face an effective income tax rate of 22.5 percent.
- Taxpayers in the 28 percent income tax bracket automatically face an effective income tax rate of 42 percent.

In 1986 at least 20 percent of elderly taxpayers had to pay taxes on an average of $3,373 of Social Security benefits,[10] and the percentage paying the tax will rise continuously in future years because the income thresholds beyond which Social Security benefits are taxable are not indexed. As inflation increases the nominal income of future retirees, more of them will pay the tax. For example, the Social Security Administration estimates that the Social Security benefit of an *average-wage* worker and spouse retiring in 2010 will be on the order of $36,000.[11]

The Effect of Bracket Shift. Because of the Social Security benefit tax, some elderly taxpayers are pushed from the 15 percent to the 28 percent tax bracket. Thus elderly workers who otherwise would pay 15 cents on an additional $1 of income must now pay 28 cents. Conceptually, and as a matter of tax law,[12] the resultant increase in taxes is fully attributable to the Social Security benefit tax. For those elderly who are pushed into the 28 percent tax bracket, the Social Security benefit tax increases their marginal tax rate by 27 percentage points.[13]

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[8]The method used to calculate the Social Security benefit tax is illustrated in Appendix A.

[9]Applies to elderly families who exceed the $25,000 or $32,000 income limits but are not yet taxed on the maximum of one-half of Social Security benefits.

[10]See Aldona Robbins, *The ABCs of Social Security* (Washington, DC: Institute for Research on the Economics of Taxation, 1988), p. 16.

[11]Board of Trustees, Federal Old-Age and Survivors and Disability Insurance Trust Funds, *1990 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds,* April 1990, Washington, DC, Table F6.

[12]The allocation of the additional tax is important because proceeds from the Social Security benefit tax are deposited in the Social Security trust fund for accounting purposes.

[13]Provided that the taxpayer is being taxed on less than one-half of Social Security benefits. If the taxpayer is being fully taxed on one-half of Social Security benefits, the increase in the marginal tax rate is 13 percentage points (from 15 percent to 28 percent). Each of these cases is illustrated in Table VI.

Effects on State and Local Income Taxes. In many places, the Social Security benefit tax affects state and local income taxes in the same way it affects the federal income tax.[14] That is, the elderly who earn $1 of income pay state and local taxes on $1.50 because of the Social Security benefit tax. Under the conditions described above:

- Elderly taxpayers who face a state and local income tax rate of 4.0 percent must pay 6.0 percent.

- Elderly taxpayers who face a state and local income tax rate of 8.0 percent must pay an effective rate of 12 percent.

There is no relationship between Social Security benefits and the services provided by state and local governments. Yet because of the way federal tax law defines adjusted gross income, state and local governments tax Social Security benefits, Social Security cost-of-living adjustments (COLAs) and even tax-exempt income.[15]

Taxes on the Elderly Middle Class. Table VI shows marginal tax rates for elderly taxpayers on different levels of income. As the table shows, it's not the poor or the rich who pay these very high marginal tax rates. It is exclusively the middle-income elderly.

- Among single retirees, the highest marginal tax rate is imposed on individuals with $24,000 to $25,000 of non-Social Security income.

- Among retired couples, the highest marginal tax rate is imposed on those with an income of about $36,000.

Elderly couples pay the maximum tax when their incomes exceed about $40,000. For these families, the Social Security benefit tax functions as a lump sum tax. Although the families who pay the tax are worse off, their marginal tax rate is unaffected by the tax.

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[14]Currently, twelve states tax Social Security benefits. The states are Colorado, Iowa, Kansas, Minnesota, Missouri, Montana, Nebraska, North Dakota, Rhode Island, Vermont, West Virginia and Wisconsin. See John R. Gist, "The Effects of State Income Tax Reform," American Association of Retired People (AARP), Public Policy Institute, Issue Paper No. 8801, April 1988.

[15]See Robbins and Robbins, "Taxing the Savings of Elderly Americans."

TABLE V

ADDITION TO MARGINAL TAX RATES DUE TO THE SOCIAL SECURITY BENEFIT TAX[1]

Federal Income Tax Bracket	Increase in Effective Marginal Tax Rates
15 Percent Bracket	+ 7.5%
28 Percent Bracket	+ 14.0%
Bracket Shift: From 15 Percent to 28 Percent[2]	+ 27.0%

[1]For taxpayers above the income thresholds of $25,000 (individual) or $32,000 (couple), but who include less than the maximum one-half Social Security benefits in income for tax purposes.

[2]Assumed to be caused by the tax on Social Security benefits. The inclusion of Social Security benefits in taxable income shifts the taxpayer from the 15 percent to the 28 percent income tax bracket. The Social Security benefit tax further increases the effective tax rate to 42 percent.

TABLE VI

MARGINAL TAX RATES FOR THE ELDERLY

SINGLE ELDERLY INDIVIDUAL[1]

Non-Social Security Income	Federal Income Tax	Social Security Benefit Tax	Total Tax Rate
$7,000	15%	0	15%
$23,000	15%	7.5%	23%
$24,000	15%	27.0%[4]	42%
$25,000	28%	14.0%	42%
$30,000	28%	0	28%

ELDERLY COUPLE[2]

Non-Social Security Income	Federal Income Tax	Social Security Benefit Tax	Total Tax Rate
$11,000	15%	0	15%
$30,000	15%	7.5%	23%
$36,000	15%	27.0%[4]	42%
$40,000[3]	15%	13.0%[3]	28%
$45,000	28%	0	28%

[1]Social Security benefits equal $7,600.

[2]Social Security benefits equal $11,400.

[3]The couple is paying the maximum Social Security benefit tax, and therefore, the tax does not directly affect the marginal tax rate. The inclusion of Social Security benefits in taxable income, however, shifts the couple from the 15 percent to the 28 percent tax bracket.

[4]Caused by bracket shift. The inclusion of Social Security benefits in taxable income causes a shift from the 15 percent to the 28 percent tax bracket, and the Social Security benefit tax causes a further increase in the effective tax rate to 42 percent.

Taxation of Capital Gains. In Table IV we illustrated a $2,000 capital gain produced by the effects of inflation alone. Table VII shows how that gain would be taxed for an elderly and a nonelderly taxpayer. In Case A, both taxpayers are in the 15 percent income tax bracket, and in Case B, both are in the 28 percent income tax bracket. In each case, the elderly taxpayer pays 50 percent more in capital gains taxes because of the effects of the Social Security benefit tax. In Case C, the Social Security benefit tax results in a shift from a 15 percent to a 28 percent tax bracket, causing the elderly taxpayer to pay a capital gains tax that is almost three times as high as that paid by a nonelderly person with the same income.

Note that very few elderly taxpayers actually face the circumstances in Case C. The case is important, however, because it illustrates the arbitrary nature of taxes imposed on elderly citizens. Furthermore, in the future more elderly taxpayers will fall into this category.

Why the Capital Gains Tax Rate Rose During the 1980s. Recognition of the fact that capital gains can be very different from ordinary income is not new. From 1922 to 1986, capital gains were treated separately from ordinary income in the tax code. This special treatment consisted of a lower tax rate for capital gains or exclusion of part of the gain for tax purposes (which resulted in a lower tax rate).[16] For example, from 1942 to 1978, taxes were levied on only one-half of capital gains income. The Revenue Act of 1978 lowered the taxable portion of the gain from 50 percent to 40 percent. Under the Tax Reform Act of 1986, however, 100 percent of capital gains income is taxed at the same rate as ordinary income.

Consider an elderly couple with a $20,000 capital gain in 1990. Table VIII shows how this gain would be taxed under various tax laws prevailing over the past decade.

- For an elderly couple with $30,500 of other income in 1990, the marginal tax rate on capital gains would be 16 percent under the tax law prevailing in 1978.
- As a result of more generous treatment of capital gains income[17] this couple's marginal tax rate would fall to 11 percent if the 1980 law prevailed today.
- The rate would fall to 9 percent if the 1983 law prevailed today.[18]
- Under the 1985 tax law, the couple benefits from (1981) rate reductions plus indexing, but this tax cut is offset by the imposition of the Social Security benefit tax (in 1983).
- The 1986 tax law eliminated the 60 percent exclusion for capital gains income, and established tax rates of 15 percent and 28 percent.
- Under the 1990 tax code, the loss of the exclusion pushes the couple from the 15 percent to the 28 percent income tax bracket, and the Social Security benefit tax further increases their marginal tax rate to 42 percent.

Table VIII also shows how other elderly couples, with different incomes, would fare if the old tax laws applied today. In all cases, the middle-income elderly have experienced soaring tax rates on capital gains income during the late 1980s.

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[16]A summary of the historical treatment of capital gains under U.S. tax law is contained in Gary Robbins, "Taxing Capital Gains," National Center for Policy Analysis, NCPA Policy Report No. 143, October 1989, Appendix A.

[17]Passed in 1978.

[18]Rate reductions occurred because of 1981 tax act.

TABLE VII

HOW TAXPAYERS WITH THE SAME INCOME FACE DIFFERENT CAPITAL GAINS TAX BURDENS[1]

Case A: 15% Bracket	Young Taxpayer	Elderly Taxpayer
Income Tax	$300	$300
Social Security Benefit Tax	0	150
Total Tax on Capital Gain	$300	$450

Case B: 28% Bracket	Young Taxpayer	Elderly Taxpayer
Income Tax	$560	$560
Social Security Benefit Tax	0	280
Total Tax on Capital Gain	$560	$840

Case C: 15% → 28% Bracket	Young Taxpayer	Elderly Taxpayer
Income Tax	$300	$300
Social Security Benefit Tax	0	540
Total Tax on Capital Gain	$300	$840

[1]Each of these cases shows the tax treatments of the $2,000 inflation-created capital gain illustrated in Table IV.

TABLE VIII-A

MARGINAL TAX RATE
ON A $20,000 CAPITAL GAIN FOR AN ELDERLY COUPLE
IF OLD TAX LAWS WERE STILL IN EFFECT TODAY

	Income Other Than Capital Gain[1]		
Prevailing Tax Law	$25,500	$30,500	$35,500
1978	14%	16%	18%
1980	10%	11%	13%
1982	9%	10%	12%
1983	8%	9%	10%
1985	6%	9%	15%
1990	23%	42%	28%

Note: The marginal tax rate is the rate paid on the last dollar of income.

[1]Assumes a 1990 Social Security benefit of $13,000.

TABLE VIII-B

AVERAGE TAX RATE
ON A $20,000 CAPITAL GAIN FOR AN ELDERLY COUPLE
IF OLD TAX LAWS WERE STILL IN EFFECT TODAY

	Income Other Than Capital Gain[1]		
Prevailing Tax Law	$25,500	$30,500	$35,500
1978	11%	13%	16%
1980	8%	9%	11%
1982	7%	9%	10%
1983	7%	8%	9%
1985	6%	7%	12%
1990	18%	20%	24%

Note: The average rate (total tax on the gain divided by the gain) differs from the marginal rate because part of the gain is taxed at a lower rate, while the remainder is taxed at a higher rate.

[1]Assumes a 1990 Social Security benefit of $13,000.

SPECIAL BURDEN FOR THE ELDERLY: GREATER RELIANCE ON CAPITAL GAINS INCOME

As noted above, the 1986 change in the tax code departed from a 65-year tradition of granting special status to capital gains income. This departure has been especially unfair to the elderly for another reason: the elderly have more capital gains income than any other population group.

- On the average, an elderly taxpayer is more than three times as likely to have a capital gain as a nonelderly taxpayer.

- The average capital gain of the elderly is more than twice as large as the capital gain of the nonelderly.

These differences do not arise because of differences among wealthy taxpayers. In fact, among the wealthy the pattern of capital gains income for young and old is very similar. The greatest differences occur among taxpayers in the middle range of income, where the Social Security benefit tax boosts marginal tax rates if the taxpayer is unlucky enough to be old. As Tables X and XI show:

- Among taxpayers with an annual income of $25,000 to $40,000 almost half of the elderly had a capital gain compared with only 10 percent for taxpayers as a whole.

- The average size of the capital gain for these elderly taxpayers was more than four times that for young taxpayers in the same income range.

TABLE IX

MIDDLE-INCOME ELDERLY TAXPAYERS WHO HAVE A CAPITAL GAIN EACH YEAR[1]

Income[2]	Percent With Capital Gain
$15,000 - $20,000	34.0%
$20,000 - $25,000	41.1%
$25,000 - $30,000	47.0%
$30,000 - $40,000	47.7%
$40,000 - $50,000	58.8%
$50,000 - $75,000	70.5%

[1]Refers only to people filing tax returns for 1986, the latest year for which statistics are available at this level of detail. At least one person on the tax return is age 65 or older.

[2]Adjusted gross income.

Source: Figures derived from *Statistics of Income—1986,* Internal Revenue Service, *Individual Income Tax Returns,* Washington, DC, 1989.

TABLE X

PERCENT OF TAXPAYERS WHO HAVE A CAPITAL GAIN IN EACH YEAR[1]

Income[2]	All Taxpayers	Elderly Taxpayers[3]	Ratio of Elderly to All Taxpayers
$ 5,000 or less	4.8%	17.6%	3.65
$ 5,000 - $10,000	4.1%	15.7%	3.85
$ 10,000 - $15,000	5.1%	20.6%	4.01
$ 15,000 - $20,000	7.6%	34.0%	4.46
$ 20,000 - $25,000	8.1%	41.1%	5.09
$ 25,000 - $30,000	9.7%	47.0%	4.86
$ 30,000 - $40,000	11.2%	47.7%	4.24
$ 40,000 - $50,000	15.0%	58.8%	3.91
$ 50,000 - $75,000	24.8%	70.5%	2.85
$ 75,000 - $100,000	41.7%	83.0%	1.99
$100,000 - $200,000	56.6%	89.8%	1.59
$200,000 or more	75.8%	94.9%	1.25
All Taxpayers	9.8%	32.0%	3.27

[1]Refers only to people filing tax returns for 1986, the latest year for which statistics at this level of detail are available.

[2]Adjusted gross income.

[3]At least one person on the tax return is age 65 or older.

Source: Figures derived from *Statistics of Income—1986*, Internal Revenue Service, *Individual Income Tax Returns*, Washington, DC, 1989.

TABLE XI

AVERAGE CAPITAL GAIN[1]

Income[2]	All Taxpayers	Elderly Taxpayers[3]	Ratio of Elderly to All Taxpayers
$ 5,000 or less	$ 988	$ 1,334	1.35
$ 5,000 - $10,000	168	276	1.64
$ 10,000 - $15,000	266	405	1.52
$ 15,000 - $20,000	441	1,328	3.01
$ 20,000 - $25,000	553	2,393	4.32
$ 25,000 - $30,000	712	2,711	3.81
$ 30,000 - $40,000	1,046	5,066	4.84
$ 40,000 - $50,000	1,606	6,346	3.95
$ 50,000 - $75,000	3,791	14,626	3.86
$ 75,000 - $100,000	12,950	35,237	2.72
$100,000 - $200,000	38,102	82,554	2.17
$200,000 or more	443,994	510,796	1.15
All Taxpayers	3,063	7,266	2.37

[1]Refers to average capital gain before exclusion for all tax returns filed for 1986, the latest year for which statistics at this level of detail are available.

[2]Adjusted gross income.

[3]At least one person on the tax return is age 65 or older.

Source: Figures derived from *Statistics of Income—1986*, Internal Revenue Service, *Individual Income Tax Returns*, Washington, DC, 1989.

SPECIAL BURDEN FOR THE ELDERLY: LONGER HOLDING PERIODS AND MORE ADVERSE EFFECTS OF INFLATION

The longer an asset is held, the more likely the capital gain from its sale will reflect the effects of inflation. Since the current system taxes inflationary gains as though they were real gains, the system imposes special penalties on people who hold assets for long periods. Unfortunately, those most likely to have held assets for many years are the elderly — as a result of saving for the years of retirement.

For example, Table XII illustrates an initial investment of $1,000 in an asset that is held for 36 years. The asset is assumed to generate real growth of 2 percent per year, while inflation increases its price at 6 percent per year. At the time of sale, the asset will be worth $16,000 — resulting in a profit of $15,000. Only $1,000 of the amount is real profit, however. The remaining $14,000 simply reflects the effects of inflation.

Consider the different ways of taxing this gain. Under the current system, the capital gains tax for an elderly person could be $6,300 (assuming a 42 percent marginal tax rate). A much fairer method would be to index the asset for the effects of inflation and tax the investor only on the asset's real appreciation. As Table XII shows, inflation indexing would reduce the tax burden by more than 90 percent.

Table XII also shows two other methods of taxing the capital gain. Under the current proposal of the Bush Administration, a 30 percent exclusion would be allowed. The tax would apply to only 70 percent of the gain, but there would be no indexing for inflation. Another method would be to keep the current capital gains tax, but exempt capital gains income from the Social Security benefit tax — taxing the elderly at the same tax rates as younger people with the same income. With respect to these alternatives, the figures in Table XII are quite revealing.

- For assets held for long periods of time, inflation-indexing is clearly better than any other alternative.
- Inflation-indexing, in this example, would result in a tax burden one-tenth as great as that generated by a 30 percent exclusion.
- For elderly taxpayers in this example, eliminating the Social Security benefit tax on capital gains income also would be more beneficial than the 30 percent exclusion.

As this example shows, the interests of many elderly taxpayers are different from the interests of many young people. Inflation-indexing and an exemption from the Social Security benefit tax should be high-priority objectives, and both are warranted on grounds of equity. As the Figure I shows, indexing would cut the tax burden by almost two-thirds. Indexing combined with an exemption from the Social Security benefit tax would reduce the tax burden by more than 95 percent.

TABLE XII

FOUR DIFFERENT WAYS OF TAXING CAPITAL GAINS INCOME
($1,000 Initial Investment)

	Current Law	Indexing	30 Percent Exclusion	No Social Security Benefit Tax
Initial Investment	$1,000	$1,000	$1,000	$1,000
Value of Investment After 36 Years (2% real growth; 6% inflation)	16,000	16,000	16,000	16,000
Capital Gain	15,000	15,000	15,000	15,000
Inflation Adjustment	0	-14,000	0	0
Exclusion	0	0	-4,500	0
Taxable Gain	15,000	1,000	10,500	15,000
Amount of Tax	6,300[1]	420[1]	4,410[1]	4,200[2]

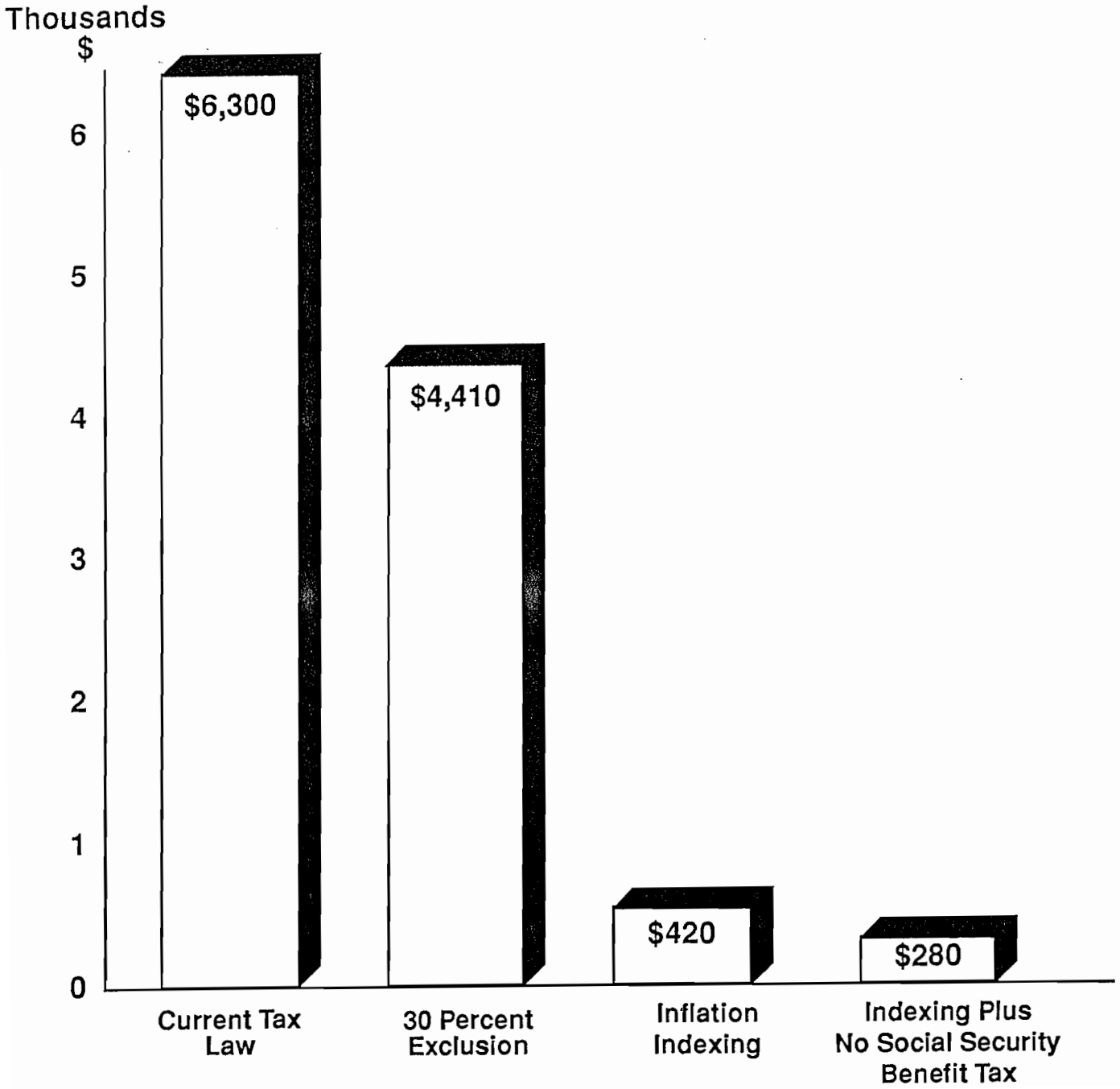
[1]Assumes a marginal tax rate of 42 percent.

[2]Assumes 28 percent federal income tax rate.

FIGURE I

CAPITAL GAINS TAX ON A $1,000 INVESTMENT AFTER 36 YEARS

(Real Return = 2%; Inflation = 6%)



WHY TAX CAPITAL GAINS AT ALL?[19]

A major obstacle to a capital gains policy that encourages investment and capital accumulation is the view that a lower capital gains tax rate is fundamentally unfair. Advocates of a high capital gains tax often argue that, in the absence of such a tax, investors would realize untaxed income. It follows that if the capital gains tax rate were lower than the tax rate applied to ordinary income, recipients of capital gains would be receiving preferential treatment under the tax code. In most cases, however, these arguments are wrong.

Most assets have value only because of the future income they are expected to produce. As a result, the value of the asset today is totally determined by the income stream it will generate. Any change in expected future earnings changes the value of the asset today. With respect to these assets, the following propositions hold:[20]

Proposition 1: **When there is an income tax, holders of assets pay the income tax indirectly through a lower sales price for those assets.**

Proposition 2: **When income tax rates change, asset prices immediately change to reflect the change in future taxes on income.**

Proposition 3: **A tax on capital gains is double taxation, even in the absence of a corporate income tax.**

These propositions are illustrated by the hypothetical investment in Table XIII. Without an income tax the asset produces an annual income (net of production costs) of $100,000 per year. At a 10 percent rate of interest, this asset has a present value (and, therefore, a current sale price) of $1 million. Note that the value of the asset is totally determined by the expected future income and the discount rate.[21]

Introducing a 28 percent income tax immediately reduces annual aftertax income to $72,000. As a result, the present value (sale price) of the asset is reduced to $720,000. Note that a 28 percent income tax reduces the value of the asset by 28 percent. If the income tax rate had been 33 percent, the value of the asset would be 33 percent lower. The holders of assets, then, do not escape taxation. They pay the income tax indirectly through the reduction in the value of the assets they hold.

Assume the asset is a patent and that there are no deductible costs associated with it. In this case, the sale price of the asset is exactly equal to the owner's capital gain. The existence of a 28 percent income tax, as we have seen, costs the owner $280,000 in terms of a lower sale price. His capital gain, therefore, is $720,000. If this capital gain also is taxed at a rate of 28 percent, the capital gains tax will equal $202,000, leaving the seller with $518,400.

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[19]A more technical presentation of the propositions discussed in this section is presented in Gary Robbins, "Taxing Capital Gains," Appendix B.

[20]Exceptions to these propositions are assets that produce untaxed income. For example the "income" (enjoyment) from collectibles (paintings, coins, etc.) is not taxed. Similarly, the "income" from an owner-occupied house also is untaxed.

[21]The discount rate will reflect risk associated with the income stream as well as the expected rate of inflation.

In this example the effective tax rate on income from capital is 48.2 percent. Of this amount, 28 percentage points are the result of the income tax, and 20.2 percentage points are the result of the capital gains tax. Far from creating equity in taxation, the capital gains tax causes the asset holder to pay an effective tax rate that is 72 percent higher than the tax rate on ordinary income. A capital gains tax plus an income tax, therefore, constitutes double taxation. *Adding a corporate income tax results in triple taxation.*

In general, asset values change every time expectations about future income change. These gains and losses should not be confused with the production of real income, however, nor should the taxation of capital gains (which is really the taxation of changes in expectations) be confused with the taxation of real income.

TABLE XIII

HOW THE INCOME TAX AFFECTS THE VALUE OF CAPITAL ASSETS

Future Earnings from an Investment

	Without an Income Tax	With an Income Tax
Annual Income[1]	$100,000	$100,000
Annual Taxes	0	$28,000
Income Net of Taxes	$100,000	$72,000

Present Value of the Investment (Current Sales Price)

	Without an Income Tax	With an Income Tax
Present Value of Income[2]	$1,000,000	$1,000,000
Present Value of Taxes	0	$280,000
Present Value of the Asset	$1,000,000	$720,000

[1]Net of production costs.

[2]Discounted at a 10 percent rate of interest.

EFFECTS ON THE FEDERAL DEFICIT

Another objection to a lower tax rate on capital gains income is that a lower tax rate would reduce federal revenue and increase the size of the federal deficit. This obligation flies in the face of almost all scholarly studies and all historical experience. A lower capital gains tax rate encourages people to sell assets, thus increasing the tax base. At the lower rate, the federal government will collect more total revenue. A capital gains tax cut is a win-win proposition. Everyone gains, including the federal government.

Revenue Effects of the Bush Administration Proposal. As an example of how a capital gains tax cut leads to a lower deficit and benefits both government and taxpayers, consider the effects of the administration's proposal:[22]

- The Bush proposal will cause the nation's output of goods and services to increase by $623 billion over the next ten years.
- Aftertax personal income will be $182 billion higher by the year 2000, increasing about $15 billion per year.
- Increased federal revenue will grow to $65 billion by 1995 and $185 billion by the year 2000.
- State and local governments will collect $106 billion in new taxes over the decade.

Other Scholarly Studies. Harvard economist Lawrence Lindsey recently reviewed the academic literature on the effects of the increase in the capital gains tax rate as a result of the Tax Reform Act of 1986.[23] Lindsey found that with only one exception, every study predicted that the recent increase in the capital gains tax rate would *reduce* long-term government revenue.[24] Lindsey's own estimate is that federal revenue would be maximized by a capital gains tax rate of about 15 percent. These findings also are consistent with the findings of the economists at the U.S. Department of the Treasury, whose studies in 1985[25] and 1988[26] and two very recent additional studies[27] all conclude that government revenue will go up when capital gains tax rates go down.

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[22]See Aldona Robbins and Gary Robbins, "The Bush Savings Plan," National Center for Policy Analysis, NCPA Policy Report No. 152, June 1990.

[23]The Tax Reform Act of 1986 increased the maximum capital gains tax rate from 20 percent to 33 percent.

[24]Predicted revenue losses for the federal government for the period 1987 through 1991 ranged from $27 billion to $105 billion as a result of the increase in capital gains tax rates. See Lawrence B. Lindsey, "Capital Gains Taxes Under the Tax Reform Act of 1986: Revenue Estimates under Various Assumptions," *National Tax Journal*, Vol. 40, No. 3, September 1987.

[25]"Report to Congress on the Capital Gains Tax Rate Reductions of 1978," U.S. Department of the Treasury, September 1985.

[26]Michael R. Darby, Robert Gillingham and John S. Greenlees, "The Direct Revenue Effects of Capital Gains Taxation: A Reconsideration of the Time Series Evidence," *Treasury Bulletin*, June 1988.

[27]Robert Gillingham, John S. Greenlees and Kimberly D. Zieschang, *New Estimates of Capital Gains Realization Behavior: Evidence From Pooled Cross-Section Data*, May 1989, U.S. Department of the Treasury, Office of Tax Analysis, OTA Paper 66; and Gerald E. Auten, Leonard E. Burman and William C. Randolph, *Estimation and Interpretation of Capital Gains Realization Behavior: Evidence from Panel Data*, May 1989, U.S. Department of the Treasury, Office of Tax Analysis, OTA Paper 67.

Historical Experience. Even a casual examination of the evidence shows a clear, unmistakable, *inverse* relationship between capital gains tax revenue and the capital gains tax rate:[28]

- From 1968 through 1978, a steady rise in the maximum tax rate on capital gains occurred because of the effects of bracket creep. Yet the amount of revenue the federal government collected from the tax was almost one-half its 1968 level by 1970 and did not regain the 1968 level until 1976.

- Following a 1978 reduction in the maximum capital gains tax rate, federal capital gains revenues rose steadily from $9.1 billion in 1978 to $12.5 billion in 1980.

- Following the 1981 cut in the maximum capital gains tax rate from 26.67 percent to 20 percent, capital gains tax revenue almost doubled in four years — rising from $12.7 billion in 1981 to $24.5 billion in 1985.

Contrary Predictions by Government Agencies. In spite of the overwhelming evidence that a reduction in capital gains tax rates will lead to an increase in federal revenues, forecasts by government agencies often point in the opposite direction. These include forecasts by the Congressional Budget Office,[29] the U.S. Department of the Treasury[30] and the widely reported forecasts of the Congressional Joint Committee on Taxation. These forecasts ignore the effect of new investment and greater economic growth. In doing so, they also ignore the primary reason why a capital gains tax cut is being proposed.

RECENT LEGISLATIVE PROPOSALS

Within the past two years, a number of proposals relating to the issues of savings and capital accumulation have been made. The following is a brief summary.

Jenkins/Archer Proposal. Sponsored by Representative Ed Jenkins (D-GA) and Representative Bill Archer (R-TX), this proposal passed the House of Representatives last year. The bill would have created a 30 percent exclusion for capital gains income for two years. After that, capital gains would be taxed at ordinary income tax rates, but asset values would be inflation-indexed.

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[28]Based on U.S. Department of the Treasury data reprinted in Ronald Utt, "Capital Gains Taxation: The Evidence Calls for a Reduction in Rates," *Heritage Foundation Backgrounder*, No. 704, May 2, 1989, Table 3, p. 10.

[29]"How Capital Gains Rates Affect Revenues: The Historical Evidence," Congressional Budget Office, March 1988.

[30]Testimony of Acting Assistant Secretary (Tax Policy) Dennis E. Ross before the Senate Finance Committee, March 14, 1989.

Bush Administration Proposal. The administration's new proposal calls for an immediate 30 percent exclusion in the first year. After a three-year phase-in period, the amount of the exclusion is determined by the length of the holding period. Only assets held for at least three years would qualify for the full 30 percent exclusion. There is no inflation indexing.[31]

Kasten/Mack/Shelby Proposal. A new Senate bill sponsored by Senators Robert Kasten (R-WI), Connie Mack (R-FL) and Richard Shelby (D-AL) is more generous than the Bush Administration plan. This proposal would establish a maximum rate of 15 percent (the original Bush Administration goal) and would also include inflation indexing. Unlike the other proposals, the Kasten/Mack plan also would apply to corporations.

The Bush Family Savings Account (FSA). Following up on another campaign pledge, the administration has proposed to allow contributions of up to $2,500 per person to FSAs. Contributions would be made with after-tax dollars, but withdrawals after seven years would be tax free. The FSA option would not be available to individuals with incomes above $60,000 ($120,000 for couples filing joint returns).[32]

The Roth Reverse IRA. Last year Senator William Roth (R-DE) made a proposal similar in concept but more generous than the Bush FSA plan. Under the Roth proposal, people would be allowed to make after-tax contributions to IRA accounts and withdrawals would be tax free.

TAXES ON OTHER INVESTMENT INCOME

This report has focused primarily on the taxation of income from capital gains. It is important to note, however, that the tax code also fails to properly index other types of investment income for the effects of inflation.

Consider, for example, a $10,000 investment made in 1971. In the first instance, assume that an asset is purchased and that it grows in value at a rate equal to the rate of inflation — 5.65 percent. By 1991, the asset will be worth $30,000 and its sale will generate a $20,000 capital gain. At a 28 percent tax rate, the total tax will be $5,600, even though there is no real profit in this example because the gain was totally created by the effects of inflation.

Now consider investing the original $10,000 in an asset that pays a fixed rate of interest of 5.65 percent. At the end of each year the taxpayer will have to pay taxes on the interest income, even though there is no real return because the rate of interest is exactly equal to the rate of inflation. (The remaining aftertax income is reinvested.)[33] Table XIV shows that in both cases the taxpayer will be left with much less capital (in real terms) because of the failure of the tax code to index properly for the effects of inflation. As the table shows, the taxation of interest income can be more unfair as the taxation of capital gains.

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[31]For an analysis of the Bush proposal, see Robbins and Robbins, "The Bush Savings Plan."

[32]For an analysis of Family Savings Accounts, see Robbins and Robbins, "The Bush Savings Plan."

[33]The aftertax rate of interest in this case is 4.07 percent (5.65 x 72%), assuming a taxpayer is in the 28 percent bracket.

In most cases, economists expect interest rates to rise in the presence of inflation by the amount of the rate of inflation. In other words the market rate of interest tends to equal the real rate of interest *plus* the rate of inflation. This is very different from the way in which inflation affects wages. For example, assume the rate of inflation rises from 0 to 10 percent. Wages will tend to rise by 10 percent. Interest rates, on the other hand, will rise by 10 *percentage points*. Indexing of the tax bracket keeps the tax rate on real wages constant (regardless of the rate of inflation), while inflation can cause the tax rate on real investment income to soar.

Table XV, for example, illustrates the return on government securities, which historically pay a real rate of return of about 2 percent. As the table shows, for any rate of inflation the market rate on these securities will equal 2 percent *plus* the rate of inflation.

Table XV also shows how the rate of inflation affects the tax rate on real income from the investment. In the absence of inflation, we have assumed that the tax rate is 28 percent — the highest marginal tax rate imposed on elderly investors. As the table shows:

- If the rate of inflation rises from 0 to 2 percent, the tax rate on real interest income doubles — rising from 28 percent to 56 percent.
- If the rate of inflation rises to 4 percent, the tax rate on real interest income rises to 84 percent.
- At a 10 percent rate of inflation, the tax rate is 168 percent.

In other words, at only modest rates of inflation taxes become totally confiscatory — taking all of the investor's real income and part of the principal as well.

TABLE XIV

AFTERTAX RETURN ON A $10,000 INVESTMENT[1]

	Capital Gain[2]	Fixed Interest Investment[3]
Initial Investment	$10,000	$10,000
Interest (Growth) Rate	5.65%	5.65%
Rate of Inflation	5.65%	5.65%
Amount Left after Taxes at End of 20 Years	$24,400	$22,200

[1]Taxpayer is assumed to be in a 28 percent tax bracket.

[2]Asset purchased and sold after 20 years.

[3]Amount invested in a fixed-interest asset. Taxes are paid annually, and the remainder is reinvested.

TABLE XV

HOW INFLATION AFFECTS TAXES ON INTEREST INCOME

Market Rate of Interest	Rate of Inflation	Real Rate of Interest	Tax Rate on Nominal Income	Tax Rate on Real Income[1]
2%	0	2%	28%	28%
4%	2%	2%	28%	56%
6%	4%	2%	28%	84%
8%	6%	2%	28%	112%
10%	8%	2%	28%	140%
12%	10%	2%	28%	168%

[1]Tax on real interest income.

CONCLUSION: A TAX AGENDA FOR AMERICANS OF ALL AGES

Capital gains taxation and the Social Security benefit tax are not merely elderly issues. These harmful taxes affect all Americans, regardless of age. The following proposals for reform would: 1) cause an increase in federal revenue and lower the federal deficit, 2) create greater equity in taxation and 3) promote savings, investment and economic growth.

Adopt Inflation Indexing for Capital Assets. Just as we have done in the case of wage income, we should index asset prices so that no one pays taxes on inflation-created profit. Inflation indexing should apply to all assets, including coin collections, stamp collections and art objects. Quite apart from the effects on economic activity, inflation indexing is required for reasons of fundamental fairness.

Adopt Inflation Indexing for Interest Income. Just as taxpayers are taxed on inflation-created profit from the sale of capital assets, so they are taxed on inflation-created interest income under the tax code. The failure to index interest payments may be even more costly to the taxpayer than the failure to index asset prices. If the tax code were properly indexed, as it is for people with wage income, taxpayers would pay taxes only on real income, not inflation-created income.

Exempt All Investment Income from the Social Security Benefit Tax. The Social Security benefit tax is a misnomer. The tax is not really a tax on Social Security benefits. Instead it is a tax on income. Currently, the tax applies to investment income, capital gains and even tax-exempt income — sources of income that have no relationship whatever to Social Security.[34]

Currently, the Social Security benefit tax applies only to a narrow range of taxable income — a range of about $4,000 to $5,000. Yet when today's young workers retire, the tax will hit middle-income taxpayers over a range of about $35,000 of income. Thus, to an important degree, the tax affects young people saving for retirement even more than it affects today's retirees.

Adopt a Lower Tax Rate for Gains on Income-Producing Assets. Quite apart from inflation indexing, taxing the profit made on the sale of income-producing assets is double taxation. The market price of these assets is already lower because of the tax on ordinary income. Current proposals for an exclusion of part of capital gains income ignore the fact that middle-income elderly taxpayers face higher marginal rates than wealthy younger taxpayers. A better idea is to set a maximum rate on capital gains for income-producing assets. A rate of, say, 15 percent, would almost certainly produce more revenue than the current system.

Reverse the Timing of Taxation on Tax-deferred Income. Congress has created a number of vehicles for tax-deferred savings. These include IRAs, 401(k) plans, Keogh plans, SEPs and employer-provided pensions. The theory behind all tax-deferral plans is that people will be in a lower tax bracket during their retirement years than during their working years. At the time these plans were sanctioned by the tax code, the theory was valid. Today it is not. The average U.S. worker will be in a higher tax bracket after retirement.

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[34]Exempting capital gains income from the Social Security benefit tax would almost certainly increase federal revenue and reduce the federal deficit. Complete abolition of the tax would cost the federal government about $4 billion the first year. Yet ultimately, this act would add about $84 billion to our annual gross national product. By the year 2000, the annual federal deficit would be lowered by $10 billion. See Robbins and Robbins, "Taxing the Savings of Elderly Americans."

In recognition of this change in tax rates, we should change the way in which people can take advantage of tax-deferred savings. People should have the option to pay taxes now in order to avoid higher tax rates during their retirement years. Accordingly, we should allow taxpayers to make after-tax contributions during their working years and make tax-free withdrawals at the time of retirement.

Apply the Special Tax Treatment of Capital Gains to Tax-deferred Savings. Most proposals to reform capital gains taxation ignore the accumulation of capital gains through tax-deferred savings. Yet the principles that apply to capital gains generally also apply to gains realized through IRA accounts, employer-sponsored pensions and other tax-deferred savings devices. In recognition of this fact, withdrawals from tax-deferred saving accounts should be taxed at a lower rate.

NOTE: Nothing written here should be construed as necessarily reflecting the views of the National Center for Policy Analysis or as an attempt to aid or hinder the passage of any bill before Congress.

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Aldona Robbins, Vice President of Fiscal Associates and Senior Fellow of the NCPA, has extensive experience with public and private retirement programs. As senior economist in the Office of Economic Policy, U.S. Department of the Treasury from 1979 to 1985, Dr. Robbins performed staff work for the Secretary in his capacity as Managing Trustee of the Social Security trust fund. Her research efforts have resulted in a model to project Social Security benefits and tax revenue.

Recent publications include *The ABCs of Social Security; Institute for Research on the Economics of Taxation (IRET) Economic Reports* entitled "Effects of the 1988 and 1990 Social Security Tax Increases" and "Facts About Catastrophic Coverage" (both with Gary Robbins); *IRET Economic Policy Bulletins* entitled "Social Security Build-Up or Shake-Down?" and "Catastrophic Health Insurance is Bad Medicine" (with Dr. William Hurwitz); "The Economic Status of the Aged: Implications for Energy Policy" (with Paul Craig Roberts) in *Proceedings of A Symposium on Energy Costs and the Elderly: The Next Twenty Years* sponsored by the U.S. Department of Health and Human Services; and articles on "End IRA Deductions, but Make Withdrawals Tax-Free" (with Gary Robbins) and "At the Heart of Medicare's Woes" (with Paul Craig Roberts) in the *Wall Street Journal.*

Gary Robbins is President of Fiscal Associates and Senior Fellow of the NCPA. Mr. Robbins has developed a general equilibrium model of the U.S. economy that specifically incorporates the effects of taxes and government spending. Before joining the private sector, he was Chief of the Applied Econometrics Staff at the U.S. Treasury Department from 1982 to 1985, Assistant to the Under Secretary for Tax and Economic Affairs from 1981 to 1982, and Assistant to the Director of the Office of Tax Analysis from 1976 to 1981.

Recent publications include an article entitled "Encouraging Private Provision for Long-Term Care" (with Aldona Robbins) in *Compensation and Benefits Management;* an *IRET Economic Policy Bulletin* entitled "Mandating Health Insurance" (with Aldona Robbins and John Goodman); an *IRET Op-Ed* entitled "Tax Catastrophes of Medicare Legislation" with Aldona Robbins and Norman Ture); and two papers prepared for the Congressional Task Force on Long-Term Health Care Policies entitled "Promoting Long-Term Care Insurance through Existing Retirement Programs" and "Tax Policies to Promote Long-Term Care" (both with Aldona Robbins). Articles entitled "Why the Tax-Reform Numbers Don't Add Up" (with David Brazell); "End IRA Deduction, but Make Withdrawals Tax-Free" (with Aldona Robbins; and "Tax Reform Aims at Very Industries Up for Protection" (with Paul Craig Roberts) have appeared in the *Wall Street Journal.*

APPENDIX A

TABLE A-I

CALCULATING THE SOCIAL SECURITY BENEFIT TAX FOR AN INDIVIDUAL

Combine:	WAGES
	+
	INVESTMENT INCOME
	+
	TAX EXEMPT INCOME
	=
	NON-SOCIAL SECURITY INCOME
	+
Add:	1/2 SOCIAL SECURITY BENEFITS
	-
Subtract:[1]	$25,000
	÷
Divide:	2
Taxable Benefits:[2]	TOTAL

[1]No tax is payable unless the total exceeds $25,000.

[2]Treated as taxable income subject to ordinary income tax rates. Maximum taxable benefits are equal to one-half of Social Security benefits.

TABLE A-II

CALCULATING THE SOCIAL SECURITY BENEFIT TAX FOR AN ELDERLY COUPLE

Combine:	**WAGES**
	+
	INVESTMENT INCOME
	+
	TAX EXEMPT INCOME
	=
	NON-SOCIAL SECURITY INCOME
	+
Add:	**1/2 SOCIAL SECURITY BENEFITS**
	-
Subtract:[1]	**$32,000**
	÷
Divide:	**2**
Taxable Benefits:[2]	**TOTAL**

[1]No tax is payable unless the total exceeds $32,000.

[2]Treated as taxable income subject to ordinary income tax rates. Maximum taxable benefits are equal to one-half of Social Security benefits.