

Four Reasons to Abolish the Social Security Benefits Tax

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Presidential candidate Hillary Clinton wants to expand Social Security for the most vulnerable retirees—specifically, widows and widowers whose incomes fall dramatically after their spouse dies. What she has not mentioned, however, is repealing a tax that targets lower-income retirees who have worked low-wage jobs: the Social Security benefits tax.



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Passed as part of the 1983 Social Security reforms, the benefits tax applies to a portion of Social Security benefits for single retirees with modified adjusted gross incomes (adjusted gross income minus tax-exempt interest) over \$25,000 and married couples over \$32,000. *The Omnibus Budget Reconciliation Act of 1993* added a second tax tier for single retirees with incomes over \$34,000 and married couples over \$44,000. To calculate the tax liability:

- Take one-half of an individual's or couple's Social Security benefits received in the tax year and add other taxable income (such as wage income or withdrawals from a tax-deferred retirement account).
- Subtract the excluded income described above to get the total modified adjusted gross income; and
- Subtract the standard or itemized deductions and personal exemptions, producing the amount of income subject to the benefits tax.

Four Reasons to Abolish the Social Security Benefits Tax. The Social Security benefits tax is complex and unfair, and there are many reasons Congress and a new administration should simply abolish it — or at the very least reform it.

Reason No. 1: Income thresholds have not been adjusted for inflation in 32 years. Statutory tax brackets are adjusted annually to reflect cost of living changes. However, the benefits tax income thresholds for single filers (\$25,000) and married filers (\$32,000) have not been adjusted for inflation since the tax took effect in 1984. This means that more seniors pay the benefits tax every year. If these thresholds were adjusted for inflation, today they would be \$57,000 for single filers and \$73,000 for married filers.

Reason No. 2: Marginal tax rates on non-Social Security income are higher for retirees than for younger workers. Because of the way the tax is applied, seniors face a much higher marginal rate on taxable income (such as wage income) than if they were earning the same income during their preretirement years.

Consider a single retiree receiving Social Security benefits and wage income. As a retiree, he must add 50 cents in benefits to his taxable income for every dollar by which his income exceeds the threshold (\$25,000) until half his benefits are subject to taxation. Thus, when retirees earn \$1.00, they must pay taxes on \$1.50. As a result, the marginal tax rate on their income is 50 percent higher than for young people with the same income.

As income rises, the tax becomes more onerous. Single retirees with incomes above \$34,000 and couples with incomes higher than \$44,000 must add 85 cents in benefits to taxable income for every dollar of income above these thresholds until 85 percent of their benefits are subject to the tax. Thus, when

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these retirees earn \$1.00, they must pay taxes on \$1.85. In this case, the marginal tax rate on their income is 85 percent higher than for young people with the same income!

Reason No. 3: The tax penalizes retirees receiving average or below-average Social Security benefits who supplement their income. Suppose a spouse retired in 2015 and received the average monthly payment, totaling about \$16,000 a year. The other spouse has not yet retired and works to supplement their income [see Figure I]. In this case:

- If the couple's wage income is below \$20,000, they owe no tax.
- If their wage income increases to \$25,000, their marginal tax rate is 15 percent.
- If their wage income increases to \$37,000, their marginal rate reaches 28 percent.
- The top marginal rate of 28 percent applies to income up to \$46,000, above which the rate falls to 15 percent!

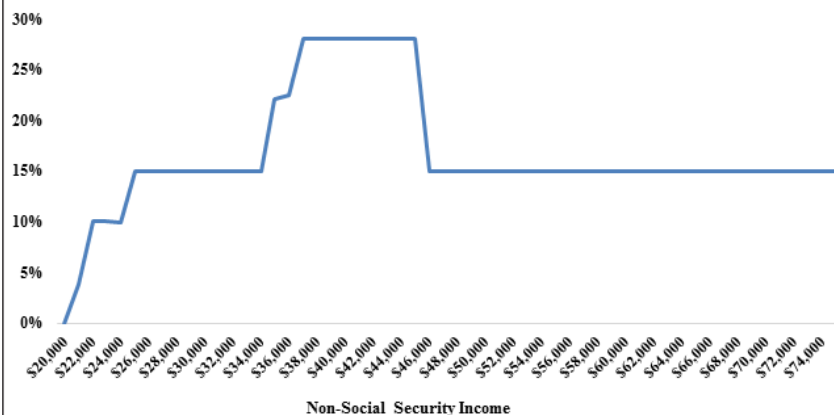
Compare this to a married couple who receive a combined \$47,000 in Social Security benefits, near the maximum amount for 2015 [see Figure II]:

- If they receive no other income, they owe no tax.
- If they receive \$18,000 from, say, a tax-deferred retirement account (not including Roth accounts, which are after-tax and not figured into taxable income), they owe a small amount of taxes and their marginal rate is 15 percent.
- If they earn \$58,000 in wage income or retirement distributions, for a total household income of \$105,000 a year, their marginal rate increases to 32 percent.
- If the couple earns an additional \$1,000, for a total of \$106,000, their marginal tax rate hits 46 percent!
- Oddly, once the couple's income hits around \$109,000, including their Social Security benefits and other income, their marginal tax falls to 25 percent!

The results of these two comparisons are telling: The Social Security benefits tax is not really a tax on Social Security benefits *per se*, but a tax on other income. The couple in Figure II can collect nearly the maximum Social Security benefits paid in 2015 and pay no tax until they earn a certain amount of taxable income. However, the couple in Figure I, who have much lower benefits, are penalized when they receive over \$20,000 in wages or tax-deferred retirement account distributions.

Reason No. 4: Increases in marginal tax rates

Figure I
Marginal Tax Rate on Wage or Investment Income
(Married Couple Receiving \$16,000 in Social Security Benefits)



Source: Author's estimates using IRS Form SA-1099 worksheet and Form 1040, with personal exemption and standard deduction amounts applied for tax year 2015.

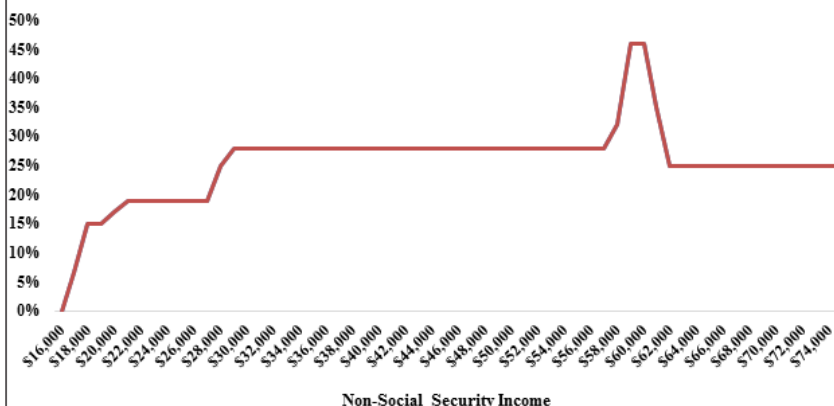
do not correspond to rises in income. Note the odd shape of the marginal tax rate curves in both figures:

- In Figure I, the highest marginal tax rate of 28 percent does not occur at the high end of the income spectrum; rather, it hits middle-income earners in the \$37,000 to \$45,000 range.
- In Figure II, the highest marginal tax rate of 46 percent hits earners in the \$59,000 to \$60,000 range. The higher-income earners have a much lower marginal tax rate of 25 percent!

Thus, the Social Security benefits tax could hardly be considered progressive.

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Figure II
Marginal Tax Rate on Wage or Investment Income
(Married Couple Receiving \$47,000 in Social Security Benefits)



Source: Author's estimates using IRS Form SA-1099 worksheet and Form 1040, with personal exemption and standard deduction amounts applied for tax year 2015.