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HOUSE WOULD TERMINATE TOP TIER TAX ON SOCIAL SECURITY BENEFITS[1]

On July 27, the House of Representatives voted to repeal the "second tier" of tax on up to 85% of Social Security benefits received by middle and upper income beneficiaries. The tax reduction would total $117.4 billion over 10 years. The vote was 265-159; there were 213 Republicans and 52 Democrats in favor. The margin, while large, was not enough to over-ride a Presidential veto. The bill must now be considered in the Senate.

On July 27, the House of Representatives voted to repeal the "second tier" of tax on up to 85% of Social Security benefits received by middle and upper income beneficiaries.

Repeal of the second tier of the tax on Social Security would be 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.

The taxation of benefits is really a tax on the <u>other</u> retirement income that pushed the retiree over the threshold and triggered the tax, and it falls on that income with an above normal marginal tax rate.

Social Security benefits are currently subject to two tiers of taxation, on up to 50% or 85% of benefits depending on the income of the recipient. The 1983 Social Security Amendments imposed taxes on up to half of Social Security benefits for single retirees with "modified adjusted gross income" (MAGI) over $25,000 and for couples with MAGI over $32,000. Affected retirees must add 50 cents in benefits to taxable income for every dollar by which their MAGI exceeds these thresholds until half of their benefits become subject to tax. (MAGI includes all ordinary adjusted gross income, plus half of Social Security benefits, plus income from tax exempt bonds.) 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 MAGI above $34,000 and couples with MAGI over $44,000 must add 85 cents in benefits to taxable income for every dollar of MAGI above these thresholds until 85 percent of their benefits become subject to tax. The 1993 Act passed the Senate when Vice President Gore cast the tie-breaking vote. It is this added layer of tax on benefits that the House voted to repeal. The revenue from this tier is dedicated to the Medicare trust fund. The bill would hold Medicare harmless by crediting the Medicare trust fund with an equal amount of other tax revenue, in effect using some future general revenues to pay a portion of Medicare outlays.

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When first imposed, taxation of benefits affected less than 10 percent of beneficiaries. Today, however, the taxation of benefits affects about 22 percent of Social Security recipients, and many more people will be affected 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.

For retirees with income over the second set of thresholds, each added dollar of income from savings raises taxable income by $1.85. If the retiree is in the 28% tax bracket, his income tax rises by 52 cents, an effective marginal tax rate of 52% on the added dollar of interest or dividends.

The taxation of benefits is really a tax on the <u>**other**</u> retirement income that pushed the retiree over the threshold and triggered the tax, and it falls on that income with an above normal marginal tax rate. The first tier of tax means that earning an extra dollar of interest, dividends, or wages above the threshold boosts taxable income by $1.50. If the retiree is in the 28% tax bracket, his tax rises by 42 cents. That is effectively a 42% 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% tax bracket. This effectively makes the tax exempt bond income taxable at half the normal tax rate.)

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If the added income is wage income, it is also subject to the 15.3% payroll tax, pushing the marginal tax rate to 57% or 67% (counting both halves of the payroll tax). Even worse, if the beneficiary is subject to the Social Security earnings test, the added tax can be greater than the added wages, a tax rate exceeding 100%!

The Social Security earnings test hits retirees who choose to collect reduced Social Security benefits before they reach the normal Social Security retirement age. If the beneficiary has wage or salary income over a limited exempt amount ($10,080 in 2000), he loses $1 in benefits for every $2 in earnings over the exempt amount. This is equivalent to a 50% add-on tax.[2]

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, because of the earnings test, the taxation of benefits at an above-normal marginal tax rate, and the payroll tax, one added dollar of wages can trigger a total tax increase of about $1.10 at the federal level, and perhaps $1.15 after state income taxes. These tax rates in excess of 100 percent are a virtual federal edict that older workers should drop out of the labor force.

These wretched tax penalties on earning additional retirement income discourage people of all ages from saving for retirement and discourage older citizens from working. Saving is essential for the income security of individuals and critical for the growth of the economy. It makes no sense to discourage saving in this fashion. Similarly, working enables seniors to earn needed income, and the effort of these most experienced and productive workers boosts the economy. As they save and work, they contribute income and payroll taxes to help fund the federal government and the Social Security system.

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There are far less damaging ways to tax Social Security benefits. Unlike employers, workers receive no income tax deduction for their half of the payroll tax. Their "contributions" are after-tax, and, as in a Roth IRA, the benefits stemming from the employee half of the tax should be tax free. Thus, no more than half of benefits should be taxable. Some amount of benefits could be made exempt from tax to protect lower income recipients. Half of any benefits above that amount should simply be added to taxable income. The amount taxable would not be based on the beneficiaries' other income, avoiding the punitive tax spikes inherent in the current system.

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President and Executive Director

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Endnotes

1. This paper was prepared at the request of the National Center for Policy Analysis.

2. Social Security's normal retirement age will be 65 for people attaining age 62 in 2000 or earlier. It will rise 2 months a year for people reaching age 62 between 2001 and 2006; remain at 66 for people attaining age 62 from 2007 through 2016, rise another 2 months a year for people attaining age 62 between 2017 and 2022, and remain at age 67 for people reaching age 62 after 2022. As the normal retirement age rises, it will throw people age 65 and 66 back under the test. A less severe earnings test — loss of $1 in benefits for every $3 in earnings over a higher threshold ($17,000 in 2000) — that used to be imposed on workers at or above the normal retirement age through age 69 was repealed this spring. Previously, workers got to shift to the less severe test and higher threshold as of January 1 of the calendar year in which they reached normal retirement age; under the new law, they are still allowed that easier test for that first portion of the year in which they reach the normal retirement age.