Taxing the Elderly

Social Security benefits were entirely free of taxes until 1983, when Congress voted to tax 50 percent of benefits above a certain income level. President Clinton raised this to 85 percent in 1993. The new Republican Congress has promised, as one of its first actions, to repeal the Clinton tax increase on Social Security recipients.

The Social Security Administration estimates that approximately 3 million families paid higher income taxes in 1994 as a result of the expanded Social Security benefits tax.

But the real impact of the tax is far greater. Because of the Social Security benefits tax, the savings and retirement plans of the vast majority of young people are much less valuable. Let's see why these groups are so profoundly affected.

How the Tax Works.

To calculate the tax, beneficiaries first add up all their non-Social Security income, including any tax-exempt interest (such as from municipal bonds). Then they add to this sum 50 percent of any Social Security benefits they received. If the total is greater than $25,000 for single persons or $32,000 for couples, one-half of the excess is included in taxable income. [See the chart on the reverse side.]

Under the pre-1993 law, additional federal income taxes were paid on up to 50 percent of all benefits. Under the Clinton tax increase, 50 percent of benefits are taxed only up to the point at which taxable income reaches $34,000 for singles and $44,000 for couples. Beyond that point, 85 percent of benefits become taxable up to the point at which 85 percent of total benefits are included in taxable income.

Higher Tax Rates for Non-Social Security Income.

Despite its name, the Social Security benefits tax is not really a tax on benefits. It is a tax on other income. No tax is paid unless a taxpayer's income reaches a certain level. Beyond that point, the tax rises as income rises. Since 85 cents of benefits is taxed for each additional $1 of income, when elderly taxpayers earn $1 they pay taxes on $1.85. The effective tax rate on their income is 85 percent higher than it otherwise would be.

Taxing Savings.

About 60 percent of the income of elderly taxpayers comes from investments (including pensions). For most younger people, the tax rate on investment income is 15 percent or 28 percent. For the elderly, the Social Security benefits tax raises the rate on income from savings by as much as 85 percent.

- Elderly taxpayers in the 15 percent income tax bracket pay an effective rate of 27.8 percent (15% x 1.85).

- Elderly taxpayers in the 28 percent tax bracket pay an effective rate of 51.8 percent (28% x 1.85).

Taxing Wages.

Perhaps the most insidious effect of this policy is to severely penalize moderate-income elderly who must continue to work after age 65. This is especially so in light of the fact that Social Security benefits are already reduced (taxed) by the earnings limit. The latter penalty reduces Social Security benefits by $1 for every $3 of wage income earned above $11,280 per year for workers age 65 to 69 — a 33 percent marginal tax rate — and by $2 for every $1 of income earned above $8,160 per year for those age 62 to 64 — a 50 percent marginal tax rate.
To see how this works, consider a single male worker whose earned income plus one-half of his Social Security benefits puts him at $25,000. If he earns one additional dollar he loses 33 cents worth of benefits, and he pays 15 cents in federal income taxes and 7.65 cents in FICA payroll taxes. Since one-half of his previously tax-free Social Security benefits are now taxable, he pays an additional tax of 5 cents. Thus from each additional dollar of earned income, he nets less than 40 cents in spendable income. His marginal tax rate is 60 percent.

Hidden Effects. Because of the way income tax returns are organized, many elderly taxpayers do not realize that the Social Security benefits tax actually taxes other income. [See the figure.] And because many states accept the federal definition of taxable income, it increases some state and local income tax rates by 50 percent.

- Capital gains income is subject to the 52 percent top rate for Social Security recipients versus 28 percent for others.
- Tax-exempt income of the elderly can be taxed at a rate of 24 percent versus a zero rate for younger taxpayers.
- Social Security cost-of-living adjustment (COLA) increases are taxed at a rate as high as 12 percent.

How the Social Security Benefits Tax Also Taxes the Young. Congress created a special tax status for employer-provided pensions, IRAs, 401(k)s, Keoghs and SEP (Simplified Employee Pension) plans to encourage retirement savings. The law allows people to avoid taxes now and defer them until their retirement years on the theory that most income will be taxed at lower rates after they retire. That is no longer true for many young workers.

- The average U.S. worker is in the 15 percent income tax bracket today.
- Yet because of economic growth and because of the Social Security benefits tax, many of these workers will see their retirement income taxed at a rate of 52 percent.

Calculating Taxable Social Security Benefits for a Couple

<table>
<thead>
<tr>
<th>Combine:</th>
<th>WAGES + INVESTMENT INCOME + TAX-EXEMPT INCOME = NON-SOCIAL SECURITY INCOME</th>
<th>Add: 1/2 SOCIAL SECURITY BENEFITS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Subtract: $32,000 x</td>
<td>A. Multiply difference up to $12,000 by: 0.50</td>
<td>B. Multiply additional difference by: 0.85^2</td>
</tr>
<tr>
<td>Add A and B to get Taxable Benefits TOTAL^3</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

^1 No tax is payable unless the total exceeds $32,000.
^2 If the result of "B" is more than 55 percent of benefits, do not add "A." Maximum taxable benefits are equal to 85 percent of Social Security benefits.
^3 Treated as taxable income subject to ordinary income tax rates.

Taxing 85 percent of Social Security benefits is not merely taxing the elderly. The provision has decreased the aftertax value of most American workers’ pension plans.

Hurting Those With Middle Incomes. The incentive effects of the increase in taxes on Social Security benefits fall primarily on those with middle incomes. Those with no income other than Social Security or only modest additional income are unaffected by the benefits tax. And those with very high incomes already pay taxes on 85 percent of their total Social Security benefits.

The tax creates a powerful disincentive for many elderly Americans to work, save or invest. By the year 2000, the Social Security benefits tax will cause an $84.4 billion annual reduction in gross national product, and federal revenue will be $10 billion lower than it otherwise would be.

The Republican Contract With America proposes to repeal the Clinton tax increase on Social Security recipients as well as the earnings test. The repeals cannot come too quickly.

This Brief Analysis was prepared by NCPA Senior Fellow Bruce Bartlett and NCPA President John C. Goodman.

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