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Repeal of the Inclusion of Social Security Benefits in Gross Income

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Focus on Tax Policy: An Introduction

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This section of The Contemporary Tax Journal includes tax policy work of SJSU MST students. We offer it here and on the journal website to showcase the range of tax knowledge the students gain from the program and to provide a public service. We think the analysis of existing tax rules and proposals using objective tax policy criteria will be of interest to lawmakers and their staff, and individuals interested in better understanding taxation.

One of the learning objectives of the SJSU MST Program is: *To develop an appreciation for tax policy issues that underpin our tax laws.*

Students learn about principles of good tax policy starting in their first MST class - Tax Research and Decision-making. The AICPA's tax policy tool, issued in 2001,[1] which lays out ten principles of good tax policy, is used to analyze existing tax rules as well as proposals for change.

Beyond their initial tax course,SJSU MST students examine the principles and policies that underlie and shape tax systems and rules in the Tax Policy Capstone course. In other courses, such as taxation of business entities and accounting methods, students learn the policy underlying the rules and concepts of the technical subject matter in order to better understand the rules and to learn more about the structure and design theory of tax systems.

The seven tax policy analyses included in this section join the growing archive of such analyses on the journal website (under "Focus on Tax Policy").

1) Transferability of the Research Tax Credit.
2) Return of the 20% Capital Gains Rate for Certain High Income Individuals.
3) Surtax on Millionaires.
4) Excessive Compensation – How Much is Too Much?
5) Increase and Make Permanent the Research Tax Credit.
6) Preferential Treatment of Capital Gains.
7) Repeal of the Inclusion of Social Security Benefits in Gross Income.

1 AICPA. (2001) Tax Policy Concept Statement 1 – Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals. Available here. Professor Nellen was the lead author of this AICPA document.

Repeal of the Inclusion of Social Security Benefits in Gross Income

By: Sujin Pradhan, *MST Student*

Background

Social Security ("SS") benefits were not taxed until 1984. The nontaxable treatment of SS benefits before 1984 was derived from administrative rulings in 1938 and 1941. The primary reason for adoption of this position was that SS benefits were made for general welfare[1]. Social security became taxable when Congress passed the "Social Security Disability Benefits Reform Act of 1984" (P.L. 98-460, 10/9/1984).

Social Security benefits are not solely funded by employees' payroll tax. Other contribution sources include employers matching payroll tax and the interest earned by the Trust Fund. Roughly 15% of the total contribution is made by the taxpayer. Hence, 85% of the SS benefits are contributed by the remaining sources. Based on this reason, the 1979 Advisory Council decided that the nontaxable treatment of the SS benefits was wrong. Thus, the proposal was made to tax half of the SS benefits with threshold exclusions set. In 1983, President Reagan signed the Amendments and up to 50% of SS benefits became taxable.[1]

In 1993, an additional set of thresholds was added and up to 85% of the SS benefits became potentially taxable for high income taxpayers. Lawmakers believed that reducing the exclusion for Social Security benefits for these high income taxpayers would enhance both the horizontal and vertical equity of the individual income tax system by treating all income in a similar manner.[2]

Current Law

Social Security benefits received during a tax year may be taxable depending on how much income a taxpayer has from other sources. In general, SS benefits are taxed if a taxpayer's sum of modified adjusted gross income (MAGI) and one half of his SS benefits exceed the base (threshold) amount.

1 U.S. House Committee on Ways and Means. (1980). Tax-free Status of Social Security Benefits: Report to Accompany H.Con Res. 351. (96th Cong., 2d Sess.) No. 96-1079.

2 Social Security Administration. (2012, Aug.).Taxation of Social Security Benefits. Retrieved from http://www.ssa.gov/history/taxationofbenefits.html

When such sum exceeds the base amount, the taxable amount is the lesser of:

1. Half of the SS benefits or,
2. Half of the excess amount over the threshold.

Section 86(c)(1) of the Internal Revenue Code of 1986 provides that the base amount for a single taxpayer is $25,000 and $32,000 for taxpayers filing joint returns. For taxpayers with an excess amount (MAGI plus half of SS benefits over the base amount) more than the adjusted base amount ($34,000 and $44,000 for single and married taxpayers, respectively), up to 85% of SS benefits may be taxable.

As evident, the tax law is complex. SS benefits are taxed under a two tier system. If the taxpayer's excess amount is more than the first tier threshold but less that the second tier threshold, up to 50 % is taxable. If the excess amount is more than the second tier amount then up to 85% is taxable.

Proposal

On January 15, 2011, Congressman Ron Paul (R-TX) introduced H.R. 150 "Senior Citizens Tax Elimination Act" (112th Congress, 2nd Session) to repeal the inclusion of SS benefits on gross income.

This bill, if enacted, will change an existing tax law on Social Security benefits. It is important that such proposals be evaluated before implementing them into tax laws. In 2001 the AICPA published a report outlining a set of ten principles as preliminary steps to analyze such tax proposals. Analysis of the "Senior Citizens Tax Elimination Act" using those ten principles follows.

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Principles of Good Tax Policy Evaluation

Equity and Fairness

Similarly situated taxpayers should be taxed similarly.

As per the current rule, certain high income taxpayers pay higher tax. Higher income taxpayers could pay tax on up to 85% of their SS benefits. Other taxpayers could pay tax on up to 50% of their SS benefits or may not pay tax at all. On the surface it seems like the existing tax law meets equity and fairness. However, the threshold amounts are not indexed for inflation. Therefore, it may not meet fairness criterion because the taxpayers who were considered high income in 1984 (or 1993) may not remain as high income taxpayers today. As a result, the number of taxpayers subject to tax is only going to increase in the future making more low income taxpayers subject to such tax. Also, the exclusion amount is the same regardless of where taxpayer lives. A taxpayer with AGI of $34,000 in Wyoming may be considered high income while a taxpayer with the same income in New York may not be considered a high income taxpayer.

If the tax on SS benefits is repealed, no taxpayers pay tax on the SS benefits regardless of their income level. While it might be helpful for low income taxpayers, the high income taxpayers will reap the benefit as well. Hence, equity and fairness is still not achieved. A better solution could be to adjust the threshold amount (index to inflation) so that lower income taxpayers will not be subject to tax.

Certainty

The tax rules should clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined.

The taxable amount for SS benefits is calculated when the taxpayers file their tax returns. While the law does explain how the amount is to be determined, the calculation itself can be very confusing. Even with the use of tax software, taxpayers will not have confidence on the correctness of the calculated amount.

Repealing the tax definitely enhances certainty because taxpayers do not need to perform the complex calculations to determine their amount of taxable SS benefits.

Convenience of payment

TA tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.

The current tax law does not meet this principle. Taxpayers are required to pay the taxes with their respective tax returns. If they failed to make payments, they will be charged with interest. While the taxpayer can elect to have a portion of the benefits withheld, it might not be in his best interest to do so if he is likely to be a low income taxpayer for that taxable year. Moreover, IRS does not pay interest for the taxes withheld.

Repeal of the tax will help meet this principle because taxpayers will not have to pay taxes on SS benefits at all.

Economy of Collection

The costs to collect a tax should be kept to a minimum for both the government and taxpayers.

Currently, it costs taxpayers money to file their tax returns and be in compliance with the SS benefits tax laws. Since the calculation is complicated it is challenging for a taxpayer to file their own tax returns. Even if the taxpayer is low income and might not owe any taxes, he still might have to get help from a tax preparer and incur compliance costs just to find out if the SS benefits are exempt.

Repealing the tax will save taxpayers money. At the same time, the IRS does not need to use its resources to audit taxpayers for noncompliance.

Simplicity

The tax law should be simple so that taxpayers can understand the rules and comply with them correctly and in a cost-efficient manner.

The current law is not simple. In addition to the complex calculation, most taxpayers have difficulty understanding MAGI. Repealing this complicated tax law will enable taxpayers to better understand the simplified tax rules. Once repealed, taxpayers have no compliance cost which makes the new law more cost-efficient.

Neutrality

The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.

Under the current law, taxpayers might be motivated to get rid of tax exempt bonds or defer capital gains, if it helps keep their MAGI below the threshold amount.

Repealing the tax will help meet neutrality because taxpayers will not be motivated to alter their decisions to keep their MAGI below the threshold amount.

Economic Growth and Efficiency

The tax system should not impede or reduce the productive capacity of the economy.

Repealing tax on SS benefits will give taxpayers more money to spend. In addition, they will save money on compliance costs. It will result though, in less revenue for the government which might lead to an increase in taxes elsewhere.

Transparency and Visibility

Taxpayers should know that a tax exists and how and when it is imposed upon them and others.

Currently, taxpayers are aware of the fact that SS benefits are taxable. However, not all taxpayers are taxed on their SS benefits. Taxpayers under the threshold amounts do not get taxed. This creates confusion about whether or not a taxpayer is exempt. Taxpayers can easily have difficulty understanding MAGI and how their taxable SS benefits are calculated.

Repeal of the tax will increase transparency and visibility as taxpayers will know that they will not pay tax on their SS benefits at all.

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Minimum Tax Gap

A tax should be structured to minimize non-compliance.

Under the current law, the likelihood of non-compliance is high. Taxpayers may not file returns simply because they do not want to pay taxes on their benefits. The IRS has to use its resources to go after such taxpayers. There are also high chances of unintentional noncompliance. Taxpayers might not file tax returns believing they are under the threshold. For example, they might not be aware that tax-exempt interest is included in the calculation of MAGI which could put them above the threshold amount making SS benefits taxable.

Repealing the tax definitely eliminates non-compliance issues.

Appropriate Government Revenue

The tax system should enable the government to determine how much tax revenue will likely be collected and when.

Revenues generated under the first tier of tax are dedicated to the Federal Old-Age and Survivors Insurance Trust Fund and Federal Disability Insurance Trust Fund. Any additional taxes from the second tier are dedicated to the Federal Hospital Insurance Trust Fund and Supplementary Medical Insurance Trust Fund.[1]

Once the tax is repealed no money is collected. Thus, the Government must find other means to supplement those funds.

Rating Summary

Equity and Fairness	-
Certainty	+
Convenience of Payment	+
Economy in Collection	+
Simplicity	+
Neutrality	+
Economic Growth and Efficiency	+/-
Transparency and Visibility	+
Minimum Tax Gap	+
Appropriate Government	-

Conclusion

Repeal of the tax on SS benefits meets most of the tax policy principles that the current law fails to meet except equity and fairness. However, this might be compensated by taxing high income individuals more on other sources of income. Also, the government must find alternative sources to fund the programs which are currently funded by the tax on SS benefits.

1 U.S. Congress. Joint Committee on Taxation. (2011, Jun. 21).JCX 36-11Description Of The Social Security Tax Base. Retrieved from https://www.jct.gov/publications.html?func=startdown&id=3798