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The 'proper' basis for taxing S.S. benefits

by Robert J. Myers

In 1938 and 1941, tax rulings were issued that Social Security benefits were not subject to income tax. This was done largely on the grounds that they are governmental gratuities (probably based on the fact that the benefits and the taxes financing them were in different titles of the Social Security Act). Periodically over the years, proposals were made to include the benefits in taxable income in the same manner as private pensions. Such proposals met with strong opposition from many people who incorrectly believed that all beneficiaries would lose some of their benefits through income taxation. In fact, low-income beneficiaries would not be affected because of personal exemptions and standard deductions.

When the 1983 Amendments solved the Social Security financing crisis then existing, through a number of changes that did not alter the program's basic nature, part of the consensus agreement was to subject Social Security benefits to income taxation for relatively high-income persons.

The actual procedure makes up to 50% of the benefits taxable for single persons with total income (including tax-exempt interest and 50% of Social Security benefits) of $25,000 or more – and likewise for married couples filing joint returns of $32,000 or more. The factor of 50% is based on the simplistic (and erroneous) theory that the worker "purchases" half of the benefit with after-tax dollars, with the employer providing the other half from post-tax dollars. Ignored is the fact that interest earnings (either real or imputed) also enter the picture. It is noteworthy that the income thresholds are not indexed, so that, over the long run, relatively more and more persons will have their benefits subject to taxation – but will not actually pay income tax if they have relatively low other income.

Recently, some have advocated taxing Social Security benefits on an equitable basis, as are private pensions. The additional receipts would be used to provide further financing for the Social Security program (as is done with the proceeds under present law). Others would use the resulting funds to reduce the general budget deficit.

As a practical matter, it would be difficult to use the approach applicable to private pensions because data are not readily available to beneficiaries as to the amount of Social Security taxes that they actually paid in the past. A larger issue is which taxes to count – OASI only, OASDI, or OASDI-HI (only the last-mentioned is reported by the Social Security Administration in its Personal Earnings and Benefit Estimate Statement). Also at issue is what should be done about self-employment taxes – consider the latter, or instead only what the employee taxes would have been? Instead, a simplified approach along the lines of the present basis is often advocated – such as making 85% of the benefits subject to taxation. To the best of my knowledge, no factual demonstration has ever been set forth as to why the 85% figure would result in good "rough justice."

Proportions of OASI Benefits "Purchased" by OASI Taxes For Several Different Bases as to Taxes Considered For Individual Retiring at Age 65 in Early 1985 (DI and HI taxes are not considered)

Category	Average Earner	Maximum Earner
Comparison of Employee Taxes Without Interest to Present Value of Benefits (at Age 65)		
Single Man	11%	14%
Single Woman	8	11
Married Couple*	6	8
Comparison of Employee Taxes With Interest to Present Value of Benefits (at Age 65)		
Single Man	28%	33%
Single Woman	22	26
Married Couple*	15	18
Comparison of Combined Employer-Employee Taxes With Interest to Present Value of Benefits (at Age 65)		
Single Man	57%	66%
Single Woman	44	52
Married Couple*	30	35

* Assumes both are the same age and only one was an earner.

NOTE: Data for present values of benefits and taxes with interest, from "A Money's Worth Analysis of Social Security Retirement Benefits" by Robert J. Myers and Bruce D. Schobel, *Transactions*, Society of Actuaries, 1983.

The accompanying table seeks to answer that question. Based on the top panel of the table, it seems that a "blanket" figure of 85% is justified because this would be on the low side for everybody, but barely so in some cases. To put it another way, these figures indicate that no more than 15% of the benefits for those retiring currently have been "purchased" on a no-interest basis for the past taxes. This basis is the proper one for income taxation and is used for contributory private pensions.

The table also shows, for informational purposes, the proportions of benefits "purchased" when account is taken of interest on past taxes paid (separately for employee taxes only and for combined employer-employee taxes).

Robert J. Myers was Chief Actuary, Social Security Administration, 1947-70; Deputy Commissioner, Social Security Administration, 1981-82; and Executive Director, National Commission on Social Security Reform, 1982-83. He is now Professor Emeritus, Temple University.

Coming in November: New area code for Society

Beginning November 11, callers should dial area code 708 to reach the Society office in Schaumburg, Illinois. This new code covers the Chicago suburbs. The current area code, 312, will remain in effect for Chicago numbers only.

A three-month transition period, from November 11 through February 9 will be provided to help callers adjust to the new area code. During the transition period, both the old and new ways of dialing calls will work.