

Taxing Issues: Social Security Benefits

Although individual taxpayers must pay tax into the Social Security system during their working years, that is not the end of the line. Depending on their income, they may also be liable for tax on Social Security benefits received in retirement.

Background: For 2010, the Social Security "wage base" is \$106,800 (the same as it was for 2009). In other words, an employee must pay the 6.2% OASDI portion of Social Security tax on the first \$106,800 of wages. The 1.45% HI portion of the tax applies to all wages. These figures are doubled for self-employed taxpayers (although half of the self-employment tax is tax-deductible).

That is pretty straightforward. Conversely, the rules for taxing Social Security benefits received in retirement are considerably more complicated.

For starters, an individual's "provisional income" determines his or her tax liability, if any. Provisional income is defined as modified adjusted gross income (regular AGI plus certain technical adjustments), plus any tax-exempt income received, plus one-half of the Social Security benefits received. If provisional income is less than the annual "base amount," none of the benefits are taxable. The base amount is \$32,000 for joint filers; \$25,000 for single filers. (For married taxpayers filing separate returns, the base amount is zero.)

However, if provisional income exceeds the base amount, the recipient is taxed on Social Security benefits. The amount depends on whether either one or two thresholds are surpassed.

1. If provisional income is between \$32,000 and \$44,000 (\$25,000 and \$34,000 for single filers), tax is paid on the lesser of (a) one-half of the Social Security benefits or (b) 50% of the amount by which provisional income exceeds \$32,000 (\$25,000 for single filers).

Example: Linda Green is a joint filer; her provisional income is \$40,000, and she receives \$10,000 in annual Social Security benefits. In this case, she must pay tax on \$5,000, since half of the benefits received exceed half of the excess over the base amount, or \$4,000. If Linda is in the 25% tax bracket overall, she must pay \$1,250 of tax on her benefits.

2. If provisional income is more than \$44,000 (\$34,000 for single filers), the calculation is more complicated. The recipient must pay tax on 85% of the amount by which provisional income exceeds \$44,000 (\$34,000 for single filers) plus the lesser of (a) the amount determined under the first threshold or (b) a base amount of \$6,000 (\$4,500 for single filers). In no event, however, can the amount exceed 85% of the benefits received.

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Note that investments generating tax-exempt income, such as municipal bonds or municipal bond funds, may increase provisional income. This category may also include interest on U.S. Savings Bonds used to pay college tuition.

This is a complex area of the tax law, and it could have an impact on retirement decisions. Obtain professional assistance concerning the implications.