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STATEMENT OF  
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DEPARTMENT OF THE TREASURY  
BEFORE THE  
COMMITTEE ON FINANCE  
UNITED STATES SENATE

Mr. Chairman and Members of the Committee:

I am pleased to be here today to present the views of the Department of the Treasury on the Administration's proposal regarding the taxation of Social Security benefits. As you know, that proposal would revise the rules for taxing Social Security benefits to make them more consistent with the rules for taxing benefits under private retirement plans, by generally increasing the amount of Social Security benefits subject to tax.

Let me emphasize at the start that we should not view the Social Security tax proposal in isolation but should see it as an integral part of the President's overall program to revitalize this Nation's economy. An indispensable element of that revitalization program is deficit reduction. For more than a decade now, large Federal budget deficits have been draining the pool of private savings, cutting into the rate of capital formation by the Nation's industry, and causing us to become dependent upon an unreliable flow of savings from abroad. The net result has been a slowdown in the rates of growth of productivity and real incomes of the American worker, and in the process we have become the world's leading debtor nation.

To turn this situation around, it is essential to shrink future Federal budget deficits. This cuts the government's demands on the financial markets, reduces interest rates, and stimulates private investment. Already there have been sizable declines in long term interest rates, attributable in large part to favorable market reaction to the Administration's budget deficit reduction proposals.

In achieving deficit reduction, we must insure that all groups contribute and do so equitably. The current proposal was designed with that principle clearly in mind.

### Current Law

The old age and survivors and the disability insurance (OASDI) programs under the Social Security system provide monthly benefits to retired workers, to disabled workers under age 65, and to their survivors and dependents. OASDI benefits are funded in part through employer contributions, *i.e.*, the employer share of OASDI taxes under the Federal Insurance Contributions Act (FICA), in part through employee contributions, *i.e.*, the employee share of OASDI taxes, and in part through earnings on those contributions. Employer contributions are made on a pre-tax basis--that is, they are not included in the employee's income or FICA wages--while employee contributions are made on an after-tax basis.<sup>1</sup>

Under current law, generally the full amount of any retirement and disability benefits provided to an employee under a private retirement plan is included in the employee's gross income and subject to tax when it is received. However, if a retirement plan provides for after-tax employee contributions, a percentage (called the exclusion ratio) of each periodic benefit received by an employee is excluded from the employee's gross income. The exclusion ratio is generally the ratio of the nominal amount of the employee's after-tax contributions (called the employee's investment in the contract) to the total benefits that the employee could expect to receive when the payments first began. The exclusion ratio is reduced to zero once the employee's investment in the contract has been fully recovered under these rules; similarly, if the employee dies before the investment has been fully recovered, the unrecovered amount may be deducted in the employee's last taxable year.

These rules ensure that contributions to a retirement plan and earnings on those contributions are taxed once and only once: when they are paid into the plan in the case of after-tax employee contributions, and when they are paid out of the plan in the case of employer contributions and plan earnings. These rules apply equally to retirement plans maintained for Federal and State employees and to plans for employees of private employers.

Although the OASDI programs provide benefits to the employee that are essentially equivalent to the retirement and disability benefits under a private retirement plan, they are not taxed in the same manner under current law. First, most lower-income

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<sup>1</sup> Self-employed individuals are subject to a similar system which places them in essentially the same position as employees. While they pay both the employee and the employer shares of OASDI taxes, half of their contributions are excluded from their income tax and Social Security tax wages.



taxpayers are completely exempt from tax on their OASDI benefits, since generally no OASDI benefits are included in gross income for taxpayers with adjusted gross incomes (plus tax-exempt interest, certain foreign-source income, and 50 percent of OASDI benefits) below a \$25,000 base amount (\$32,000 in the case of a married couple filing a joint return). In effect, such taxpayers have a 100 percent exclusion ratio. In 1990, about 83.6 percent of returns with OASDI benefits were exempt from tax on those benefits under this rule.

Furthermore, under current law higher-income taxpayers are only required to include in gross income the lesser of (1) 50 percent of their OASDI benefits or (2) a phase-in amount equal to the excess of their adjusted gross incomes (plus tax-exempt interest, certain foreign-source income, and 50 percent of OASDI benefits) over the base amounts described above. In effect, they have an exclusion ratio between 50 and 100 percent. By contrast, if OASDI benefits were subject to the same rules as benefits under a private retirement plan, few if any taxpayers would have an exclusion ratio as high as 50 percent. In fact, the Social Security Administration has calculated that, under the economic and demographic assumptions used for projecting the actuarial soundness of the Social Security system over the next 75 years, and assuming no changes in current law (other than the normal annual increases in the FICA wage base), no groups of past, current or future retirees would have exclusion ratios higher than 15 percent. In addition, only current or future groups of retirees with high lifetime earnings and long earnings histories would have exclusion ratios as high as 15 percent, and a large majority would have significantly lower exclusion ratios.

The disparity in treatment between OASDI benefits and benefits under a private retirement plan has been recognized since the taxation of OASDI benefits was first proposed by the Advisory Council on Social Security in 1979. Based on then-current law, some members of the Council argued unsuccessfully that, "to correspond with the tax treatment of private pensions, the taxable part of the Social Security benefit should be 83 percent" rather than 50 percent, corresponding to an exclusion ratio of 17 percent.

### **Administration Proposal**

The Administration's proposal would make the rules for taxing OASDI benefits more consistent with the rules for taxing benefits under private retirement plans, by increasing the maximum taxable portion of OASDI benefits from 50 to 85 percent.<sup>2</sup>

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<sup>2</sup> An alternative that has been suggested is to calculate exclusion ratios with respect to OASDI benefits on an individual basis in essentially the same way as private pensions. However,

In effect, this change would reduce the minimum exclusion ratio for higher-income taxpayers who are subject to tax on their benefits from 50 to 15 percent. The portion of adjusted gross income and OASDI benefits in excess of the base amounts that taxpayers in the phase-in range (*i.e.*, taxpayers whose income or OASDI benefits are not high enough to require them to include the full 85 percent of OASDI benefits in gross income) are required to include in gross income would also be increased from 50 to 85 percent.<sup>3</sup> Additional taxes resulting from the increase would be paid to the hospital insurance (HI) trust fund, which is expected to be exhausted in 1999. Other taxes on OASDI benefits would continue to be paid to the Social Security trust fund.

The Administration's proposal would place higher-income retirees with high lifetime earnings and long earnings histories in approximately the same position as they would be under the tax rules applicable to private retirement plans, while continuing the relatively favorable treatment of other higher-income retirees with lower lifetime earnings or shorter earnings histories.

Most retirees would be unaffected by the Administration's proposal. The proposal would not change the portion of OASDI benefits that is used to determine whether a taxpayer is exempt from tax on his or her OASDI benefits. Thus, the proposal would continue to exempt the great majority of taxpayers from tax on their OASDI benefits. More importantly, it would not subject any taxpayers to tax on their benefits who are not already subject to tax.

The Administration's proposal would have minimal effects on lower-income taxpayers. Of the tax filers projected to receive OASDI benefits in 1994, 22.9 million (or 67 percent) are projected to have family economic incomes of less than \$40,000.<sup>4</sup> Only 790,000 (or about 3.5 percent) of these filers will be liable for additional tax on their OASDI benefits under the Administration's proposal. They will pay \$220 million in

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this would be difficult to implement quickly and would impose significantly higher tax burdens on many individuals, especially lower-income individuals, than under current law or the Administration's proposal.

<sup>3</sup> Corresponding changes would be made to the treatment of OASDI-equivalent benefits under the Railroad Retirement system, which are subject to the same tax rules as OASDI benefits under current law.

<sup>4</sup> "Family economic income" is a broad measure of the income of a family that has long been used by the Treasury Department to describe the distribution of tax burdens.



additional taxes, or an average of \$23 per month, representing 4.5 percent of the total revenue raised by the proposal. The remaining 96.5 percent of filers in this category will have no additional tax liability. Overall, filers in this category (including both filers with taxable OASDI benefits and those without) will pay an average of 83 cents per month more in additional taxes overall.

The Administration's proposal will primarily affect higher-income taxpayers. Of the tax filers projected to receive OASDI benefits in 1994, 4.4 million (or 12.8 percent) are projected to have family economic incomes of over \$75,000. These filers will pay an average of \$90 per month in additional taxes, representing almost 70 percent of the total revenue raised by the proposal. Available data suggests that filers in these categories generally have high net worths, probably averaging over \$1 million.

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In conclusion, the Administration's proposal regarding the taxation of Social Security benefits will move towards greater equality in tax treatment between recipients of OASDI benefits and participants in private retirement plans without subjecting any taxpayers to tax on their benefits who are not already subject to tax on those benefits.

#### Lautenberg Amendment

The Committee requested comments by the Department of the Treasury on the Lautenberg amendment to the budget resolution (S. Con. Res. 18), expressing the sense of the Senate that the Finance Committee should try to avoid any increases in taxes on OASDI benefits for beneficiaries with incomes of less than \$32,000 (\$40,000 for married couples filing joint returns). The Department of the Treasury understands that, if the amendment were followed, the Administration's proposal would only apply to beneficiaries with incomes over these dollar thresholds, while beneficiaries with incomes under these thresholds would continue to be subject to current law without any change in the base amounts under current law.

The Department of the Treasury does not support the higher thresholds specified in the Lautenberg amendment because they would work against the goal of parity between recipients of OASDI benefits and recipients of benefits under a private retirement plan, and would create new disparities among recipients of OASDI benefits, by creating a new class of taxpayers entitled to preferential treatment (in addition to those who are already exempt from tax on their OASDI benefits because their incomes are below the base amounts under current law). It would also significantly complicate the rules for calculating the extent to which OASDI benefits are taxed for all individuals currently subject to the tax, while producing a relatively small savings for only a small number of individuals.

**Conclusion**

Mr. Chairman, that concludes my formal statement. I will be pleased to answer any questions that you or other Members may wish to ask.