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Social Security and Income Tax

This page gives general income tax guidance with citations, and should not be used as the basis for tax advice in individual cases. Taxpayers should always seek guidance from competent tax professionals, and should use this page only as an aid to asking the right questions.

Note: Social Security disability benefits and retirement benefits are treated the same for income tax purposes. SSI benefits are not subject to income tax.

Common questions:

- How should I handle income taxes on my retroactive lump sum payment of disability benefits?
- How much of my ongoing Social Security disability benefit is subject to income tax?
- What about my attorney fee for the disability appeal — is it deductible?
- I owe most of the Social Security lump sum to a long term disability carrier, so how do I avoid double taxation?

Lowering the tax impact of a lump sum. Congress has provided a special election allowing a client to take advantage of the tax exempt base amount for each of the retroactive years represented in a Social Security lump sum. [I.R. Code §86(e); see I.R.S. Publication 915] In most cases, this special election will be desirable, because it enables the taxpayer to offset the lump sum with a multiple of base amounts, described below. Also, the election removes the need to amend prior tax returns.

SSA-1099. Social Security is required to send each benefit recipient an SSA-1099 by February 1 of the following year, specifying how much of the Social Security benefit received in the lump sum was really a payment for some prior year or years. The 1099 also lists the attorney fee. These SSA-1099 forms are often inaccurate, and the taxpayer must use award notices to double check the 1099.

Income Tax on Social Security Benefits.

The Basic Rule. Up to 50% of Social Security benefits are taxable if total "provisional income" (adjusted gross income, tax-exempt interest and one half of Social Security benefits) exceeds a base amount: $25,000 for single taxpayers and $32,000 for married taxpayers filing jointly. At this level, taxes are payable on the lesser of (1) 50% of Social Security benefits received, or (2) one half of the difference between provisional income and the applicable base amount. Fortunately, this is the end of the income taxation picture for most recipients of disability benefits.

The Second Tier. A second tier of income tax - reaching up to 85% of Social Security benefits received - kicks in (1) for single taxpayers with provisional income over $34,000, (2) for married taxpayers filing jointly with provisional income over $44,000, and (3) for all married taxpayers who file separate returns, but do not live apart.

For these second-tier categories, income taxes are payable on the *lesser* of (A) 85% of Social Security benefits or (B) the total of (1) 85% of the difference between provisional income and the applicable *adjusted* base amount ($34,000/$44,000), plus (2) the lesser of (a) half the benefits or (b) $4,500 (for singles / $6,000 (for married couples filing jointly). The adjusted base amount for married persons filing separately but living together is zero; taxes are payable on the lesser of 85% of benefits or 85% of provisional income.

Attorney Fee Deduction. If a taxpayer discovers that some of the Social Security lump sum - when added to regular benefits received in the same year - turns out to be taxable, the attorney fee may be deducted from income, but only to the same extent that Social Security is taxed. For example, if a taxpayer paid tax on 50% of SSA benefits received, the taxpayer may deduct half of the attorney fee paid or incurred during the same year. [IRS Revenue Ruling 87-102] The taxpayer faces the burden of filing an itemized return, of course, and this limited deduction is further subject to the " 2% of adjusted gross" ceiling on miscellaneous itemized deductions.

Worker' s Compensation Reduction. Social Security disability may be reduced for worker's compensation and other public disability benefits. Oddly, the amounts deducted are <u>included</u> as benefits received for purposes of income tax. In effect, state worker' s compensation is rendered <u>taxable</u> in an amount equal to the Social Security reduction, but only to the extent that Social Security is taxable for the year. [I.R. Code §86(d)(3)]

Auxiliary [child or spouse] benefits. Benefits are included in the taxable income of the person who has the legal right to receive them. For example, a child's benefits are added to the child's other income (if any) to determine taxability, even though the benefits are paid on the parent's earnings record. The child receives a separate SSA-1099.

Income Tax Withholding. Voluntary Tax Withholding (VTW) from Social Security benefit income will help some taxpayers avoid quarterly estimated tax payments or an onerous lump sum due by April 15th. To begin or modify a withholding request, submit completed IRS Form W-4V to a local Social Security office. The available withholding rates are 7, 10, 15 or 27 percent. The form is posted on the Social Security web site: <u>www.ssa.gov/taxwithhold.html</u>

LTD reimbursement. What if the taxpayer used all or part of a Social Security back payment to reimburse a long-term disability carrier? Special tax relief is available under §1341 of the Internal Revenue Code, again avoiding the need to amend a prior tax return. See IRS Publication 525. If the repayment to the LTD carrier is under $3,000, the taxpayer gets a deduction on the current year's tax return. For repayments over $3,000, the taxpayer chooses either the deduction or a tax credit for the excess tax paid in the prior year. A subtle tax issue to watch: LTD reimbursements to the carrier also cause "phantom" taxable income in some cases, due to the separate 1099 forms issued for the year by SSA and by the carrier.

Other Tax Notes.

Deductions for the Self-Employed. Since the self-employed pay all of their Social Security and Medicare taxes, these workers receive a Social Security tax deduction and an income tax deduction at tax time, designed to achieve parity with the employed, who do not pay FICA or income tax on the value of the employer's FICA tax payment. For the Social Security tax deduction, the self-employed deduct 7.65% of net earnings before computing the tax at 15.3%. For the income tax deduction, 50% of the net social security tax liability (after applying the Social Security tax deduction above) is deducted from gross earnings as a business expense.

Tax Liens and Social Security. To collect delinquent taxes, the IRS is authorized by the Taxpayer Relief Act of 1997 to impose an administrative offset against disability or retirement benefits. 26 USC 6334(c). The offset provision applies to delinquent income taxes, corporate withholding and FICA withholding falling within the 10-year look back range of the law.

The collection is 15% per month, with no income exemptions or set asides. There are no collections from children's benefits, from benefits already being reduced to collect a Social Security overpayment, or from SSI benefits.

For concurrent (Social Security and SSI) beneficiaries, 15% of the Social Security benefit will be taken, with no corresponding increase in SSI for the month. Couples jointly liable for a tax debt will lose 30% of their Social Security income during the collection period.

Note that beneficiaries do have the right to appeal the accuracy of the debt, to offer a compromise lump sum, to request repayment at a slower rate, and to seek a hardship exemption. These rights are administered by the IRS, not Social Security. Debt collection activity should stop while the beneficiary seeks this relief.

The elderly and disabled incur income tax liability from a surprising array of sources, including self-employment efforts, the taxable portion of Social Security benefits as detailed above, emergency withdrawals from IRAs, gains from the early and unplanned sale of investments, and damage awards that include lost wages. The vast majority of this population incurred the tax liability unexpectedly, and without adequate resources to cover the debt. These beneficiaries now face the loss of critical Social Security income through a tax lien, and affected individuals should be encouraged to contact the Taxpayer Advocate Service, a remarkably helpful and independent entity within the IRS: 1-877-777-4778 (toll free), or www.irs.gov/advocate.