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If a taxpayer’s modified adjusted gross income plus one-half of the Social Security benefits (including tier I railroad retirement benefits) received during the taxable year *exceeds* certain base amounts, then a portion of the benefits received must be included in gross income and taxed as ordinary income. “Modified adjusted gross income” is a taxpayer’s adjusted gross income (disregarding foreign income, savings bonds, adoption assistance program exclusions, the deductions for education loan interest and for qualified tuition and related expenses) *plus* any tax-exempt interest income received or accrued during the taxable year.[[1]](#footnote-1)

A taxpayer whose modified adjusted gross income plus one-half of his Social Security benefits exceed a base amount is required to include in gross income the *lesser* of (a) 50 percent of the excess of such combined income over the base amount, *or* (b) 50 percent of the Social Security benefits received during the taxable year.[[2]](#footnote-2) The “base amount” is $32,000 for married taxpayers filing jointly, $25,000 for unmarried taxpayers, and zero ($0) for married taxpayers filing separately who have not lived apart for the entire taxable year.[[3]](#footnote-3)

In a case of first impression, the Tax Court held that for purposes of IRC Section 86(c)(1)(C)(ii), the term “live apart” means living in separate residences. Thus, where the taxpayer lived in the same residence as his spouse for at least 30 days during the tax year in question (even though maintaining separate bedrooms), the Tax Court ruled that he did not “live apart” from his spouse at all times during the year; therefore, the taxpayer’s base amount was zero.[[4]](#footnote-4)

In addition to the initial tier of taxation discussed above, a percentage of Social Security benefits that exceed an adjusted base amount will be includable in a taxpayer’s gross income. The “adjusted base amount” is $44,000 for married taxpayers filing jointly, $34,000 for unmarried taxpayers, and zero ($0) for married individuals filing separately who did not live apart for the entire taxable year.[[5]](#footnote-5) If a taxpayer’s modified adjusted gross income plus one-half of his or her Social Security benefits exceed the adjusted base amount, his gross income will include the *lesser* of (a) 85 percent of the Social Security benefits received during the year, *or* (b) the sum of – (i) 85 percent of the excess over the adjusted base amount, plus (ii) the

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Smaller of – (A) the amount that is includable under the initial tier of taxation (see above), or (B) $4,500 (single taxpayers) or $6,000 (married taxpayers filing jointly).[[6]](#footnote-6)

*Example 1.* A married couple files a joint return. During the taxable year, they received $12,000 in Social Security benefits and had a modified adjusted gross income of $35,000 ($28,000 plus $7,000 of tax-exempt interest income). Their modified adjusted gross income plus one-half of their Social Security benefits [$35,000 + (½ of $12,000) = $41,000] is greater than the applicable *base amount* of $32,000 but less than the applicable *adjusted base amount* of $44,000; therefore, $4,500 [the lesser of one-half of their benefits ($6,000) or one-half of the excess of $41,000 over the base amount (½ × ($41,000 - $32,000), or $4,500)] is included in gross income.

*Example 2.* During the taxable year, a single individual had a modified adjusted gross income of $33,000 and received $8,000 in Social Security benefits. His modified adjusted gross income plus one-half of his Social Security benefits [$33,000 + (½ of $8,000) = $37,000] is greater than the applicable *adjusted base amount* of $34,000. Thus, $6,550 [the lesser of 85 percent of his benefits ($6,800), or 85 percent of the excess of $37,000 over the adjusted base amount (85 percent × ($37,000 - $34,000), or $2,550) plus the lesser of $4,000 (the amount includable under the initial tier of taxation) or $4,500] is included in gross income.

An election is available that permits a taxpayer to treat a lump sum payment of benefits as received in the year to which the benefits are attributable.[[7]](#footnote-7)

Any workers’ compensation pay that reduced the amount of Social Security received and any amounts withheld to pay Medicare insurance premiums are included in the figure for Social Security benefits.[[8]](#footnote-8) In *Green v. Comm*.,[[9]](#footnote-9) the taxpayer argued that his Social Security disability benefits were excludable from gross income[[10]](#footnote-10) because they had been paid in lieu of workers’ compensation. The Tax Court determined, however, that Title II of the Social Security Act is *not* in the nature of workers’ compensation. Instead, the Act allows for disability payments to individuals regardless of employment. Consequently, the taxpayer’s Social Security disability benefits were includable in gross income.

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In a case of first impression, the Tax Court held that a taxpayer’s Social Security disability insurance benefits (payable as a result of the taxpayer’s disability due to lung cancer that resulted from exposure to Agent Orange during his Vietnam combat service) were includable in gross income under IRC Section 86 and were not excludable under IRC Section 104(a)(4). The court reasoned that Social Security disability insurance benefits do not take into consideration the nature or cause of the individual’s disability. Furthermore, the Social Security Act does not consider whether the disability arose from service in the Armed Forces or was attributable to combat-related injuries. Eligibility for purposes of Social Security disability benefits is determined on the basis of the individual’s prior work record, not on the cause of his disability. Moreover, the amount of Social Security disability payments is computed under a formula that does not consider the nature or extent of the injury. Consequently, because the taxpayer’s Social Security disability insurance benefits were not paid for personal injury or sickness in military service within the meaning of IRC Section 104(a)(4), the benefits were not eligible for exclusion under IRC Section 104(a)(4).[[11]](#footnote-11)

Tax-exempt interest is included in the calculation made to determine whether Social Security payments are includable in gross income.[[12]](#footnote-12) It has been determined that although this provision may result in indirect taxation of tax-exempt interest, it is not unconstitutional.[[13]](#footnote-13)

Railroad retirement benefits (other than Tier I benefits) are taxed like benefits received under a qualified pension or profit sharing plan. For this purpose, the Tier II portion of the taxes imposed on employees and employee representatives is treated as an employee contribution, while the Tier II portion of the taxes imposed on employers is treated as an employer contribution.[[14]](#footnote-14) Legislation enacted in 2001 provides increased benefits for surviving spouses and adjustments to the Tier II tax rates.[[15]](#footnote-15)

1. IRC Sec. 86(b)(2). [↑](#footnote-ref-1)
2. IRC Sec. 86(a)(1). [↑](#footnote-ref-2)
3. IRC Sec. 86(c)(1). [↑](#footnote-ref-3)
4. *McAdams v. Comm*., 118 TC 373 (2002). [↑](#footnote-ref-4)
5. IRC Sec. 86(c)(2). [↑](#footnote-ref-5)
6. IRC Sec. 86(a)(2). [↑](#footnote-ref-6)
7. IRC Sec. 86(e). [↑](#footnote-ref-7)
8. Rev. Rul. 84-173, 1984-2 CB 16. [↑](#footnote-ref-8)
9. TC Memo 2006-39. [↑](#footnote-ref-9)
10. Under IRC Section 104(a)(1). [↑](#footnote-ref-10)
11. *Reimels v. Comm*., 123 TC 245 (2004), *affi’d*, 436 F.3d 344 (2d Cir. 2006); *Haar v. Comm*., 78 TC 864, 866 (1982), *aff’d*, 709 F.2d 1206 (8th Cir. 1983), followed. [↑](#footnote-ref-11)
12. IRC Sec. 86(b)(2)(B). [↑](#footnote-ref-12)
13. *Goldin v. Baker*, 809 F.2d 187 (2nd Cir. 1987), cert. denied, 484 U.S. 816 (1988). [↑](#footnote-ref-13)
14. See IRC Sec. 72(r)(1). [↑](#footnote-ref-14)
15. See Secs. 101 and 204, The Railroad Retirement and Survivors’ Improvement Act of 2001. [↑](#footnote-ref-15)