Funding Sources

# What is it?

In general, there are three basic sources for funding for retirement income: social security, formal retirement plans, and individual savings. These are sometimes referred to as the three legs of a stool upon which the funding of retirement income can be based.

*Social Security.* The first major source of retirement income is social security (and similar governmental plans). Studies have shown that the percentage of total income that retirees depend on from social security ranges from 100% for many low to moderate income individuals to 33% for even many moderately high income individuals.

There is great concern about the future of social security because social security is essentially funded by providing benefits to current retirees from social security taxes paid by current workers, and the ratio of current workers to current retirees has been declining for some time now. While theoretically there is a social security trust fund that is designed to accumulate funds to pay for future social security benefits, the fund has essentially been borrowed to pay for other government expenditures.

Social security does provide payments that are adjusted for inflation, thus providing some protection against inflation. Social security benefits for retirement are discussed in detail below.

*Formal Retirement Plans.* The second major source of retirement income is formal retirement plans. For this purpose, formal retirement plans include anything from a qualified plan to an individual retirement account (IRA) that is tax favored for retirement purposes. Such tax favored retirement accounts may provide an upfront deduction or exclusion from income, income tax deferral, qualified distributions excludable from income, or some combination of these tax benefits.

In the past, many qualified retirement plans were of the defined benefit type, that is, the retiree could generally expect to receive a fixed benefit in the form of an annuity for life (or the life of the worker and the worker’s spouse) generally based on a formula that considered the worker’s age, years worked, and level of income earned. The employer funded the plan and generally bore the risk of investment results. The employee often had a good idea of the retirement income he could expect from such a plan. There has been a major decline in the number of defined benefit plans in recent years and the number of employees who can expect income of this type from a qualified plan. Furthermore, there is some concern over possible underfunding of some of these qualified plans.

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In addition, there has been a decrease in plans where the employer sets aside amounts in the retirement account separate from the employee’s wages. Correspondingly, there has been an increase in plans, such as 401(k) plans, where the employee must elect to defer some of the employee’s own current wages to provide for future retirement benefits. The employer may match some of the employee’s contribution in some of these plans. However, it is now up to most employees to set aside the money in such plans for their future retirement. And the employee generally bears all or most of the investment risk.

Employees can also set aside amounts in individual retirement accounts which offer a variety of different tax benefits. The IRA owner bears the investment risk.

*Individual Savings.* The third major source of retirement income is individual savings. This is becoming of increasing importance as the uncertainty about the future of social security and formal retirement plans grows. (Note that for some retirement plans, such as 401(k)s and IRAs, it is the employee who is setting aside his own money for retirement. So there might be some overlap for these categories.)

For many individuals, equity in a home can be a significant source of retirement income.

Advantages

1. When one recognizes the sources of retirement income and acknowledges the trends in social security and formal retirement plans, the importance to the individual of setting aside amounts for retirement, through elective deferrals in qualified plans, contributions to IRAs, and personal savings, becomes quite apparent. Hopefully, this will lead to action before it is too late.

2. Knowing the sources of retirement income allows one to quantify (and qualify) some sources of income, and to plan accordingly.

# Disadvantages

1. Failure to recognize the sources of retirement income may lead to the failure to accumulate sufficient funds for retirement, leading to inadequate retirement income. It may also lead to a dangerous lack of diversification and over reliance on a particular source.

2. The inability to quantify some sources of retirement income may prevent adequate planning for retirement income.

# What are the Tax Implications?

The different sources of retirement income, including different investments and different formal retirement vehicles, have different tax characteristics and benefits. There may be some flexibility as to where certain sources are invested and which tax rules apply. Special tax rates, tax exclusions or deductions, or tax deferral can lead to greater accumulations and greater retirement income.

The focus here is on retirement income. Therefore, the discussion of social security benefits is limited to retirement benefits for the worker and the worker’s spouse and survivor benefits for a spouse. (While not generally discussed here, social security can provide many other benefits, such as disability benefits or benefits for children.) As noted above, social security is a significant percentage of many individual’s retirement income, but there is some uncertainty about its future.

Retirement

An individual is entitled to a retirement benefit if he or she: (1) is fully insured; (2) is at least age 62 throughout the first month of entitlement, and (3) has filed application for retirement benefits.[[1]](#endnote-1)

The retirement age when unreduced benefits are available increased by two months a year for workers reaching age 62 in 2000-2005; will be age 66 for workers reaching age 62 in 2006-2016; increases by two months a year the retirement age for workers reaching age 62 in 2017-2022; and will be age 67 for workers reaching age 62 after 2022 (i.e., reaching age 67 in 2027).[[2]](#endnote-2)

The Normal Retirement Age (NRA) for spouse’s benefits (presently age 66) moves upward in exactly the same way as that for workers; the Normal Retirement Age for a surviving spouse’s benefits also rises but in a slightly different manner (beginning for surviving spouses who attain age 60 in 2000 and reaching a Normal Retirement Age of 67 in 2029).

Reduced benefits will continue to be available at age 62, but the reduction factors will be revised so that there is a further reduction (up to a maximum of 30% for workers entitled at age 62 after the retirement age is increased to age 67, rather than only up to 20% for entitlement at age 62 under previous law and for those reaching age 62 before 2000 under current law).

A retirement benefit which starts at or after Normal Retirement Age equals the worker’s PIA (primary insurance amount). But a worker who elects to have benefits start before Normal Retirement Age will receive a monthly benefit equal to only a percentage of his PIA (the PIA will be reduced by 5/9 of 1% for each of the first 36 months he is under Normal Retirement Age when payments commence and by 5/12 of 1% for each such month in excess of 36).[[3]](#endnote-3)

As a general rule, a person taking reduced retirement benefits before Normal Retirement Age will continue to receive a reduced rate after Normal Retirement Age.

Spouse’s Benefit

An individual is entitled to spouse’s benefits on a worker’s Social Security record if: (1) the worker is entitled to retirement or disability benefits, (2) the spouse has filed an application for spouse’s benefits, (3) the spouse is not entitled to a retirement or disability benefit based on a primary insurance amount equal to or larger than one-half of the worker’s primary insurance amount, and (4) the spouse is either age 62 or over, or has in care a child under age 16, or disabled, who is entitled to benefits on the worker’s Social Security record.[[4]](#endnote-4) The spouse of a worker must also meet *one* of the following conditions: (1) the spouse must have been married to the worker for at least one year just before filing an application for benefits, or (2) the spouse must be the natural mother or father of the worker’s child, or (3) the spouse was entitled or potentially entitled to spouse’s, surviving spouse’s, parent’s, or childhood disability benefits in the month before the month of marriage to the worker, or (4) the spouse was entitled or potentially entitled to a surviving spouse’s, parent’s, or child’s (over 18) annuity under the Railroad Retirement Act in the month before the month of marriage to the worker. A spouse is “potentially entitled” if he or she meets all the requirements for entitlement other than the filing of an application and attaining the required age.

The spouse is entitled to a divorced spouse’s benefit on the worker’s social security record if: (1) the worker is entitled to retirement or disability benefits, (2) the spouse has filed an application for divorced spouse’s benefits, (3) the spouse is not entitled to a retirement, survivor’s, or disability benefit based on a primary insurance amount which equals or exceeds one-half the worker’s primary insurance amount, (4) the spouse is age 62 or over, (5) the spouse is not married, and (6) the spouse had been married to the worker for 10 years before the date the divorce became final.

If the spouse of a retired or disabled worker is caring for the worker’s under-age-16 or disabled child, the monthly benefit equals 50% of the worker’s PIA regardless of his or her age. If the spouse is not caring for a child, monthly benefits starting at Normal Retirement Age likewise equal 50% of the worker’s PIA; but if the spouse chooses to start receiving benefits at or after age 62, but before Normal Retirement Age, the benefit is reduced.

If the spouse chooses to receive, and is paid, a reduced spouse’s benefit for months before Normal Retirement Age, he or she is not entitled to the full spouse’s benefit rate upon reaching Normal Retirement Age. A reduced benefit rate is payable for as long as he or she remains entitled to spouse’s benefits.

Survivor Benefits

Mother’s or Father’s Benefits

The surviving spouse of a fully or currently insured worker is entitled to a mother’s or father’s benefit at any age if: (1) caring for a child under age 16, or disabled before age 22, who is entitled to a child’s benefit on the deceased worker’s account; (2) the child is the survivor’s own child or is legally adopted; (3) the surviving spouse is unmarried; (4) no widow’s or widower’s benefit is available; (5) no retirement benefit is available based on the surviving spouse’s own work record which is equal to or larger than the mother’s or father’s benefit; and (6) application has been filed for benefits.[[5]](#endnote-5)

The amount of a mother’s or father’s benefit is equal to 75% of the deceased spouse’s PIA (primary insurance amount). However, because of the family maximum limit, the monthly benefit actually received by the surviving spouse may be less. (See Maximum Family Benefits below.) A surviving divorced mother’s or father’s benefit is the same amount. However, benefits paid to a divorced mother or father will not be reduced because of the limit on total family benefits; and such benefits are not counted in figuring the total benefits payable to others on the basis of the deceased worker’s account.

A mother’s or father’s benefit ceases when the youngest child reaches age 16 (unless a child is disabled). The surviving spouse can receive no further benefits until becoming entitled to a surviving spouse’s benefit at age 60 (or a disabled widow’s or widower’s benefit at age 50). The period during which the surviving spouse is entitled to no benefits is known as the Black-Out Period. The fact that a child’s benefits will continue after age 16 does not entitle his mother or father to a continuation of benefits.

Widow or Widower’s Benefits

A surviving spouse is entitled to benefits based on the deceased spouse’s earnings if: (1) the surviving spouse is age 60 or over, or is at least age 50 but not age 60 and is disabled, (2) the worker died fully insured, (3) the surviving spouse is not entitled to a retirement benefit that is equal to or larger than the worker’s primary insurance amount (PIA), (4) the surviving spouse has filed an application for benefits, and (5) in most circumstances the surviving spouse has not remarried unless the remarriage happened after the surviving spouse turned 60.[[6]](#endnote-6)

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In addition, one of the following conditions must be met: (1) the surviving spouse was married to the deceased worker for at least nine months just before he or she died (see exceptions below); (2) the surviving spouse is the biological mother or father of the worker’s child (this requirement is met if a live child was born to the worker and the surviving spouse, although the child need not still survive); (3) the surviving spouse legally adopted the worker’s child during their marriage and before the child reached age 18; (4) the surviving spouse was married to the worker when they both legally adopted a child under age 18; (5) the worker legally adopted the surviving spouse’s child during their marriage and before the child reached age 18; or (6) the surviving spouse was entitled or potentially entitled to wife’s, husband’s, father’s, mother’s, parent’s, or childhood disability benefits, or to a survivor spouse’s, child’s (age 18 or over) or parent’s annuity under the Railroad Retirement Act, in the month before the month the surviving spouse married the deceased worker.

The 9-month duration of marriage requirement is waived if the worker’s death was accidental or it occurred in the line of duty while a member of a uniformed service serving on active duty, or if the surviving spouse who was married to the worker at the time of death, was previously married to and divorced from the worker and the previous marriage had lasted nine months.

If the surviving spouse is Normal Retirement Age or older when benefits commence, the monthly benefit is equal to 100% of the deceased worker’s PIA (the amount the worker would have been entitled to receive upon Normal Retirement Age) plus any additional amount the deceased worker was entitled to because of delayed retirement credits (the delayed retirement credit is discussed below). If the worker was receiving benefits before Normal Retirement Age, the surviving spouse is entitled to an amount equal to the reduced benefit the worker would have been receiving had he lived (but not less than 82.5% of the PIA).

Computing Benefits

The Primary Insurance Amount (PIA) is the basic unit used to determine the amount of each monthly benefit payable under social security. A disabled worker – or a retired worker whose old-age benefits start at Normal Retirement Age – receives monthly benefits equal to the PIA. Retired workers whose old-age benefits start *after* Normal Retirement Age also receive an additional delayed retirement credit.

Monthly benefits for members of an insured’s family (dependent’s and survivor’s benefits) are all figured as percentages of the worker’s PIA. The total amount of monthly benefits payable on a worker’s social security account is limited by a “maximum family benefit” which is also related to the worker’s PIA. The Wage Indexing Method is what is used to calculate a person’s PIA. This method is based on “indexed” earnings over a fixed number of years after 1950. (Indexing is a mechanism for expressing prior year’s earnings in terms of their current dollar value.)

The “wage indexing” method uses a formula to determine the PIA.[[7]](#endnote-7)

* **Step I.** Index the earnings record.
* **Step II.** Determine the individual’s Average Indexed Monthly Earnings (AIME).
* **Step III.** Apply the PIA formula to the AIME.

The AIME is based on Social Security earnings for years after 1950. This includes wages earned as an employee and/or self-employment income.

Only earnings credited to the person’s Social Security account can be used up to the Social Security wage base for that year ($97,500 in 2007).

The AIME is based on the earnings record after wages have been indexed. Indexing creates an earnings history which more accurately reflects the value of the individual’s earnings in comparison with the national average wage level at the time of eligibility. Earnings for each year are indexed up to and including the “indexing year,” the second year before the worker reaches age 62, or dies or becomes disabled before age 62.

Wages are indexed by applying a ratio to the worker’s earnings for each year beginning with 1951. The ratio is the “indexing average wage” for the second year before the year of the worker’s eligibility for benefits or death, divided by the “indexing average wage” for the year being indexed. Thus, indexed earnings for each year are computed as follows:

|  |  |  |
| --- | --- | --- |
| Worker’s Actual Earnings  (Up to the Social Security Maximum  for Year to be Indexed | X | Average Earnings of All Workers  Year (Second year before Eligibility or Death) |
| Average Earnings of  All Workers for Year being Indexed |

*Example:* Mr. Martin earned $10,000 in 1982 and reached age 62 in 2007. The indexing average wage for 2005 (his “indexing year”) was $36,952.94 and the indexing average wage for 1982 was $14,531.34. Indexed earnings for 1982 are computed as follows:

|  |  |
| --- | --- |
| $36,952.94 | X $14,531.34 = $25,429.82 |
| $10,000 |

Indexed earnings of $25,429.82 are used in place of actual earnings for 1982 in Mr. Martin’s AIME computation.

In computing a person’s AIME, the following steps are taken:

* **Step I.** Count the *number* of years *after* 1950 (or after year person reached age 21, if later) and *up to* (not including) the year of attaining age 62 (or the year of disability or death, if before age 62). The number of years counted is the number of *computation elapsed years.*
* **Step II.** Subtract five from the number of computation elapsed years when computing the AIME for *retirement* or *death benefits.* The number remaining (if less than two, use two) is the *number of computation base years* to be used in computing the AIME.

The number of years to be subtracted for *disability benefits* is scaled according to the worker’s age, under the following schedule:

|  |  |
| --- | --- |
| Worker's Age  in year of disability | Number of  dropout years |
| Under 27 | 0 |
| 27 through 31 | 1 |
| 32 through 36 | 2 |
| 37 through 41 | 3 |
| 42 through 46 | 4 |
| 47 and over | 5 |

*Example:* An insured worker attained age 62 on December 2, 2006 and filed his application for retirement benefits on January 3, 2007. There are 40 elapsed years, counting the years from age 22 (1966) through 2005. The number of computation years is 35 (40 minus 5).

* **Step III.** List Social Security earnings in the *computation base years.* (Social Security earnings limits are listed under the heading “AIME.”) Computation base years are years *after* 1950, up to and *including* the year of death, or the year *before* entitlement to retirement or disability benefits. (A person is not entitled to benefits until an application for benefits is filed.)

Notice that the year of death is included as a computation base year – but the year in which an application is made for retirement or disability benefits is not included. However, for benefits payable for the next year after application is made for retirement or disability benefits, the AIME for retirement or disability benefits will be recomputed, and earnings for this final year substituted for the lowest year if the result is a higher AIME.

Where benefits are being estimated for entitlement at some future time, use anticipated earnings (but not over the Social Security maximum) for future computation base years.

* **Step IV.** Index earnings in each computation base year up to but not including the “indexing year.”
* **Step V.** From the list of indexed earnings (and nonindexed earnings for and after the “indexing year”), select years of highest earnings (same number as found in **Step II**). Selected years need not be in consecutive order.
* **Step VI.** Total indexed and nonindexed earnings for selected years are divided by the number of months in the number of years found in **Step II**, dropping cents. This is the person’s Average Indexed Monthly Earnings (AIME).

If a person does not have earnings covered by Social Security in as many years as are required to be used as benefit computation years, total earnings must nevertheless be divided by the number of months in the required number of years. In other words, one or more years of zero earnings must be used.

The Primary Insurance Amount is determined by applying a formula to the Average Indexed Monthly Earnings (AIME). Where first eligibility is in calendar year 2007, the Primary Insurance Amount is the sum of three separate percentages of portions of the AIME. It is found by adding 90% of the first $680 or less of the AIME, plus 32% of the AIME in excess of $680 through $4,100, plus 15% of the AIME in excess of $4,100.

If the resulting PIA is not an even multiple of 10¢, it is rounded to the next lower multiple of 10¢.

The PIA is then subject to cost-of-living increases beginning with the year of first eligibility.

Maximum Family Benefits

The following formula determines the Maximum Family Benefit for those who reach age 62 or die in 2007:[[8]](#endnote-8)

(1) 150% of the first $869 of PIA, plus

(2) 272% of PIA over $869 through $1,255, plus

(3) 134% of PIA over $1,255 through $1,636, plus

(4) 175% over $1,636.

The result is the family maximum. (The final figure should be rounded to the next lower multiple of $.10 if not an even multiple of $.10.) The Maximum Family Benefit is subject to cost-of-living increases beginning with the year of first eligibility. The numbers in the calculation change each year based on the change in the nation’s average wages, but the percentages stay the same.

For a disabled worker and family, benefits may not exceed the lesser of 85% of the Average Indexed Monthly Earnings (AIME) on which the worker’s disability benefit is based, or 150% of the disability benefit payable to the worker alone. However, in no case will a family’s benefit be reduced below 100% of the benefit which would be payable to the worker alone.

Cost-of-Living Increases

The Social Security Act provides for automatic increases in benefits and in the maximum earnings base (earnings subject to social security taxes) due to changing economic conditions.[[9]](#endnote-9)

The automatic increases in benefits are determined by increases in the Consumer Price Index for All Urban Wage Earners and Clerical Workers prepared by the Department of Labor. The increases in the maximum earnings base are determined from increases in average nationwide wages, if there has been a cost-of-living increase in benefits for the preceding December.

Individuals using the “wage indexing” benefit computation method are entitled to cost-of-living increases beginning with the year of first eligibility (the year of attaining age 62, or disability or death before age 62). The PIA is calculated for the year of first eligibility and the cost-of-living increases in that year and subsequent years will be added. As long as eligibility exists in any month of the year, the PIA will be increased by the automatic benefit increase percentage applicable to the check sent in January of the following year.

*Example:* Mr. Jones attains age 62 in November 2005 and waits until January 2007 to apply for benefits. The PIA is calculated and will be increased by the automatic cost-of-living benefit increases applicable to December 2005 and December 2006. The resultant PIA will be payable in the benefit paid for January 2007.

Delayed Retirement Credit

Workers who continue on the job receive an increase in retirement benefits for each year they work between age 65 and 70.[[10]](#endnote-10) Note that this is *not* an increase in the worker’s PIA. Other benefits based on the PIA, such as those payable to a spouse, are not affected.

For those individuals who turn age 62 in 2005 or later, delaying the receipt of Social Security benefits past normal retirement age will increase the person’s benefits by 2/3 of 1% for each month (or 8% per year) after reaching normal retirement age. A person’s maximum delayed retirement credit will be reached at age 70.

|  |  |  |
| --- | --- | --- |
| Delayed Retirement Credit Rates | | |
| **Attain Age 62** | **Monthly**  **Percentage** | **Yearly**  **Percentage** |
| 1979-1986 | 1/4 of 1% | 3% |
| 1987-1988 | 7/24 of 1% | 3.50% |
| 1989-1990 | 1/3 of 1% | 4% |
| 1991-1992 | 3/8 of 1% | 4.50% |
| 1993-1994 | 5/12 of 1% | 5% |
| 1995-1996 | 11/24 of 1% | 5.50% |
| 1997-1998 | 1/2 of 1% | 6% |
| 1999-2000 | 13/24 of 1% | 6.50% |
| 2001-2002 | 7/12 of 1% | 7% |
| 2003-2004 | 5/8 of 1% | 7.50% |
| 2005 or after | 2/3 of 1% | 8% |

Working after Retirement

A Social Security beneficiary will lose part or all of his benefits if he is under the normal retirement age for all of 2007 and earns over $12,960. However, an alternative test applies in the initial year of retirement if it produces a more favorable result. A beneficiary will lose benefits if he reaches normal retirement age in 2007 and earns more than $34,440. Earnings in and after the month in which a person reaches normal retirement age are not included in determining total earnings for the year.[[11]](#endnote-11)

The annual exempt amounts ($12,960 and $34,440 in 2007) will be increased each year as wage levels rise.

A beneficiary who has reached Normal Retirement Age before the current year can earn any amount without loss of benefits. Regardless of how much earnings are earned in the year of attaining normal retirement age, no benefits are withheld for the month in which normal retirement age is reached, or for any subsequent month.

If the beneficiary is at normal retirement age or older, no benefits will be lost because of his earnings. If he is under the normal retirement age, the following rules apply:

* If more than $34,440 is earned in 2007 before the month the beneficiary reaches normal retirement age, $1 of benefits will be lost for each $3 of earnings over $34,440. Only earnings earned in the months before the month the beneficiary reaches normal retirement age are counted in determining whether the beneficiary has excess earnings. The age at which this withholding rate applies will increase as the normal retirement age increases.
* If not more than $12,960 is earned in 2007 by a beneficiary under normal retirement age for the entire year, no benefits will be lost for that year.
* If more than $12,960 is earned in 2007 by a beneficiary under normal retirement age for the entire year, $1 of benefits will ordinarily be lost for each $2 of earnings over $12,960.
* But, no matter how much is earned during 2007, no *retirement* benefits in the *initial year of retirement* will be lost for any month in which the beneficiary neither: (1) earns over $1,080 if retiring in a year before the year he reaches normal retirement age, nor (2) renders any substantial services in self-employment.

The initial year of retirement is the first year in which he is both entitled to benefits and has a month in which he does not earn over the monthly exempt wage amount (as listed above) and does not render substantial services in self-employment.

In determining the amount of benefits for a given year that will be lost, two factors must be taken into consideration: (1) the amount of the person’s excess earnings for the year, and (2) the months in the year that can actually be charged with all or a portion of the excess earnings potentially chargeable in the initial year of retirement.

Both wages earned as an employee and net earnings from self-employment are combined for purposes of determining the individual’s total earnings for the year. Only “excess earnings” are potentially chargeable against benefits.

Excess earnings are charged first against all benefits payable on the worker’s account for the first month of the year. If any excess earnings remain, they are charged against all benefits payable for the second month of the year, and so on until all the excess earnings have been charged, or no benefits remain for the year. However, a month cannot be charged with any excess earnings and must be skipped if: (1) the individual was not entitled to benefits for that month, (2) was at normal retirement age or over in that month; (3) did not earn over $1,080 (in 2007) in a year before the year he reaches normal retirement age; or (4) did not render substantial services as a self-employed person in that month.

If the excess earnings chargeable to a month are less than the benefits payable to the worker and to other persons on his account, then the excess is chargeable to each beneficiary in the proportion that the original entitlement rate of each bears to the sum of all their original entitlement rates.

*Example 1:* Dr. Brown partially retires in January 2007 at the age of 62, with a PIA of $1,200. He practices for three months in 2007 and earns $30,000. The remainder of his initial year of retirement is spent in Florida playing golf. Despite the fact that Dr. Brown has excess earnings in 2007 that would, under the annual test, cause a benefit loss of $8,520, he will lose only the $3,600 in benefits for the three months during which he performed substantial services in self-employment because 2007 is his initial year of retirement.

*Example 2:* Dr. Smith, who partially retired in 2006 at age 62, practices for four months in 2007 and earns $32,000. As 2007 is his second year of retirement, the monthly earnings test does not apply. His benefits will be reduced by $1 for each $2 of earnings over $12,960. This means that Dr. Smith’s benefits in 2007 will be reduced by $9,520 (½ of the amount in excess of $12,960).

*Example 3:* Mr. Martin is 68 years old and has not retired. He earns $35,000 a year. Mr. Martin receives retirement benefits of $700 a month. Because he is over the normal retirement age, he loses none of his benefits by working.

Income Taxation of Social Security Benefits

Social Security retirement, survivor, and disability benefits may be subject to income taxation in some cases.[[12]](#endnote-12) The person who has the legal right to receive the benefits must determine if the benefits are taxable. For example, if a parent and child both receive benefits, but the check for the child is made out in the parent's name, the parent must use only the parent's portion of the benefits in figuring if benefits are taxable. The portion of the benefits that belongs to the child must be added to the child's other income to see if any of those benefits are taxable.

If the only income a person receives is Social Security benefits, the benefits generally are not taxable and he probably does not need to file a return. However, if a person has other income in addition to benefits, he may have to file a return even if none of the benefits are taxable.

If the total of a person's income plus half of his benefits is more than the *base amount*, some of the benefits are taxable. Included in the person's total income is any tax-exempt interest income, excludable interest from United States savings bonds, and excludable income earned in a foreign country, United States possession, or Puerto Rico.

The base amount is as follows depending upon a person's filing status:

* $32,000 for married couples filing jointly.
* $-0- for married couples filing separately and who lived together at any time during the year.
* $25,000 for other taxpayers.

If a person is married and files a joint return, the person and his spouse must combine their incomes and their Social Security benefits when figuring if any of their combined benefits are taxable. Even if the spouse did not receive any benefits, the person must add the spouse's income to his when figuring if any of his benefits are taxable.

*Example:* Jim and Julie Smith are filing a joint return for 2006 and both received Social Security benefits during the year. Jim received net benefits of $6,600, while Julie received net benefits of $2,400. Jim also received a taxable pension of $10,000 and interest income of $500. Jim did not have any tax-exempt interest income. Jim and Julie's Social Security benefits are not taxable for 2006 because the sum of their income ($10,500) and one-half their benefits ($9,000 ÷ 2 = $4,500) is not more than their base amount ($32,000).

The amount of benefits to be included in taxable income depends on the person's total income plus half his Social Security benefits. The higher the total, the more benefits a person must include in taxable income. Depending upon a person's income he may be required to include either up to 50% or up to 85% of benefits in income.

50 Percent Taxable

If a person's income plus half of his Social Security benefits is more than the following *base amount* for his filing status, up to 50% of his benefits will be included in his gross income.

* $32,000 for married couples filing jointly.
* $-0- for married couples filing separately and who lived together at any time during the year.
* $25,000 for all other taxpayers.

85 Percent Taxable

If a person's income plus half of his Social Security benefits is more than the following *adjusted base amount* for his filing status, up to 85% of his benefits will be included in his gross income.

* $44,000 for married couples filing jointly.
* $-0- for married couples filing separately and who lived together at any time during the year.
* $34,000 for other taxpayers.

If a person is married filing separately and *lived with* his spouse at any time during the year, up to 85% of his benefits will be included in his gross income.

1. 42 USC §402(a). [↑](#endnote-ref-1)
2. 42 USC §416(l). [↑](#endnote-ref-2)
3. 42 USC §402(q). [↑](#endnote-ref-3)
4. 42 USC §402(b). [↑](#endnote-ref-4)
5. 42 USC §402(g). [↑](#endnote-ref-5)
6. 42 USC §§402(e), (f). [↑](#endnote-ref-6)
7. 20 CFR Part 404. [↑](#endnote-ref-7)
8. 42 USC §403. [↑](#endnote-ref-8)
9. 42 USC §415(i). [↑](#endnote-ref-9)
10. 42 USC §402(w). [↑](#endnote-ref-10)
11. 42 USC §403(b). [↑](#endnote-ref-11)
12. IRC Sec. 86. [↑](#endnote-ref-12)