POLITICS AND POLICY

Social Security proposals would lift cap for payroll taxes, end 'double taxation' of income

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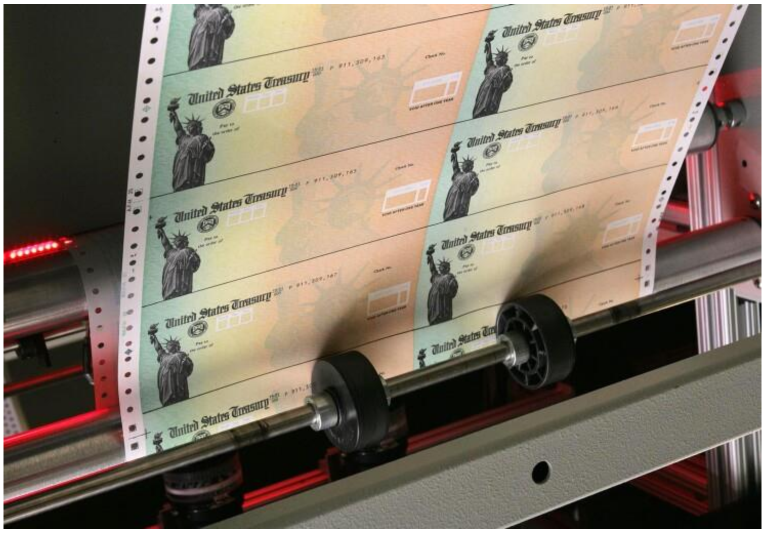

Dennis Brack/Bloomberg News

With alarm bells going off regularly about Social Security's solvency, lawmakers are coming forward with a series of proposals meant to head off potentially unavoidable benefits cuts.

One of the latest ideas — a bill from Rep. Angie Craig, a Democrat from Minnesota — would bring additional money into the system by making higher earners bear payroll taxes on more of their income while also eliminating what some argue is double taxation of income for Social Security purposes. The net effect would be to obtain more money from those who can presumably most afford it while providing greater benefits to those most dependent on Social Security.

Craig's "You Earned it, You Keep It Act," introduced in August, would repeal all federal taxation of Social Security benefits starting in 2023. Individual filers now owe some federal taxes on Social Security payments if they make a "combined income" — a designation taking into account adjusted gross income, non-taxable interest and Social Security payments — of $25,000 or more. Joint filers owe if they have a combined income of $32,000 or more. Twelve states, including Colorado, Connecticut and New Mexico, levy their own taxes on the benefits.

Would-be reformers have long noted these limits have not been adjusted for inflation since they were introduced in the 1980s. In being set so low, they force a majority of Social Security recipients to pay back at least part of the benefits that many consider too meager. Any money the federal government loses from eliminating the taxes would be made up with transfers out of a Treasury coffer known as "America's checkbook," which holds collected tax monies for funding U.S. government operations.

The ability of individuals across different income and wealth tiers to access the financial markets has massively increased in the last two years..

Nancy Altman, president of the non-profit group Social Security Works, said taxes on the benefits are known to be "very unpopular with the American people." Many see the system as resulting in "double taxation," she added, as many workers' incomes are taxed once in the form of payroll taxes and then a second time when they draw Social Security benefits.

"Most people with Social Security benefits are already quite low-income," Altman said. "And more and more people are being required to pay those taxes because the thresholds are not indexed."

The second part of the legislative proposal would require high earners to pay payroll taxes on income of $250,000 or more a year. Current law prevents payroll taxes from being applied to annual earnings above $147,000.

If Craig's bill became law, there would still be a window for earnings between $147,000 and $250,000 in which payroll taxes wouldn't apply. But since the lower threshold is adjusted upward in accordance with the average annual increase in wages while the upper threshold remains the same, that window would steadily shrink until it disappeared over about 20 years.

In a letter to Craig, the Social Security Administration's Office of the Chief Actuary estimates the proposed changes would extend the solvency of the Social Security trust fund to 2060. Otherwise a reckoning is projected for 2035, when benefits would have to be reduced to roughly 80% of their current level.

Other proposals would use similar means to more or less achieve the same goal. One of the most prominent, from Social Security Subcommittee Chairman Rep. John Larson, a Democrat from Connecticut, would subject earnings of $400,000 or more to payroll taxes. Unfortunately, said Marc Goldwein, senior vice president and senior policy director at the Committee for a Responsible Federal Budget, revisions to the original version of Larson's bill have increased promised benefit payments to the point that the fund would end up less stable in the long run.

Each of these proposals faces the usual political hurdles. But even if adoption were likely, there are practical objections.

Leibel Sternbach, a financial consultant with expertise in Social Security matters, said critics of the current system too often forget that the amount of Social Security benefits that retirees and others receive is directly tied to how much they've paid into the system over the years. So the more high earners have to pay in, the more those earners will be able to draw out upon retirement.

"It's not a welfare program," he said. "So if you raise that cap, you'll just be paying out more in benefits."

As for Craig's proposal, Sternbach sees it as nothing more than a bid to win retirees' votes. Any real solution, he said, will most likely have to involve a combination of delaying the age of retirement, taxing various retirement accounts to a greater extent and cutting back on certain benefits.

Congress will do its best to avoid doing anything that will harm current recipients for fear of retribution come election time, Sternbach said. Any pain will most likely be felt by workers who are either too young or too busy to worry about retirement at the moment.

Sternbach said financial planners have an important role to play in forecasting likely changes to Social Security and helping younger clients find ways to compensate for any losses resulting from the need to shore up the system.

"You need to be thoughtful, rather than go ahead with just the default, because otherwise you're playing into their hands, and you are probably not going to come out ahead," he said.

Mike Zeiter, owner of Foundations Financial Planning in Carthage, Missouri, said he understands why so many people question the reasons for taxing Social Security benefits. Since workers' earnings are already taxed once to pay into the Social Security fund, why should they be taxed a second time when they're pulled out?

Yet another criticism, Zeiter said, is that retirees could come out better in the long run if they were allowed to invest their savings in retirement accounts rather than being forced to pay them into Social Security.

No matter the solution, Altman said that one thing is hardly in doubt. Congress will eventually act to shore up Social Security. The program is too popular and too essential to too many voters' lives for politicians to risk their careers over benefit cuts and broken promises.

"There is no question: They'll never let it go insolvent," Altman said. "And there's still plenty of time. Insolvency is still more than a decade away."

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