Institute on Taxation and Economic Policy
1616 P Street, N.W. • Washington, D.C. 20036 • (202) 299-1066

Assessing Missouri's Income Tax Treatment of Social Security Benefits
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Early in the 2007 legislative session Missouri Governor Matt Blunt and House Speaker Rod Jetton made eliminating the state's personal income tax on Social Security benefits a priority. In May, the legislature passed a bill that would eliminate the income tax on Social Security benefits for some better-off seniors. This bill is currently awaiting Governor Blunt's signature. This policy brief describes how Social Security benefits are currently taxed and discusses alternatives for tax reform that are better targeted to fixed-income Missouri retirees.

How Social Security Benefits are Currently Taxed

Since 1984, the federal income tax has applied to some of the Social Security benefits earned by upper-income retirees. Missouri is one of fifteen states that tax Social Security benefits. Like the federal government, each of these states exempt Social Security benefits from tax for most low- and middle-income seniors.

Prior to the changes made during the 2007 legislation session, Missouri and the federal government taxed Social Security benefits in the same way. In fact, most Social Security recipients pay no federal or state income tax on their benefits under current law. The Social Security Administration found that less than one-third of current beneficiaries pay federal income taxes on their benefits. Above certain income levels, however, benefits gradually become taxable. The formula is somewhat complex, but for example:

- Couples with $20,000 in annual Social Security benefits and less than $42,000 in total income pay no tax at all on their benefits.
- At higher income levels, a growing portion of benefits must be reported as income. Thus, at $44,000, couples with $20,000 in benefits would be taxed on $1,000, or 5 percent of their total benefits. The share gradually rises, until above $67,000, 85 percent of benefits must be reported. That's the maximum.

Social Security benefits taxable under current law for couples with $20,000 in benefits

Total income	Amount of benefits subject to tax	% of benefits subject to tax
Up to $42,000	$ —	—
44,000	1,000	5%
46,000	2,000	10%
48,000	3,000	15%
50,000	4,000	20%
52,000	5,000	25%
54,000	6,000	30%
55,180	7,003	35%
56,350	7,998	40%
57,520	8,992	45%
58,700	9,995	50%
60,000	11,100	56%
65,000	15,350	77%
67,000	17,000	85%

- For single Social Security recipients, the phase-in starts at $30,000 for a person with $10,000 in benefits, and rises to the maximum of 85 percent above $44,000 in total income.

Why Are Some Social Security Benefits Subject to Tax?

The federal government began taxing a portion of Social Security benefits in 1984, and increased the maximum amount subject to tax to 85 percent in 1993. The idea was to treat Social Security benefits more like other retirement income, such as pensions and IRA distributions. For most retirees, the vast majority of Social Security benefits are income that has never been taxed:

- Of the payroll tax contributions that are initially made to Social Security, half are made by employers—which means these benefits have not been taxed.
- The Social Security contributions made by employers and by employees earn interest over the working life of an employee, and those earnings are untaxed as well.

As a result, experts calculated that 85 percent of Social Security benefits reflected previously untaxed income beyond the already-taxed Social Security contributions that retirees made during their working lives. This is why Congress chose to tax some of the Social Security benefits of upper-income families. For the vast majority of retirees, Social Security benefits go completely untaxed.

Impact of House Bill 444 on Social Security Taxation

During the 2007 legislative session, the Missouri legislature passed a bill which would gradually remove Social Security benefits and some publicly funded retirement income from the state's income tax base within six years for Missourians age 62 or older. However, these exemptions are limited to individuals with income less than $85,000 and married couples with income less than $100,000. Taxpayers with income above the exemption level would still get some tax cuts, because their Social Security benefits or retirement income will be taxed on how much their income exceeds the exemption level (instead of being taxed on all of their retirement benefits). Estimates are that the legislation will cost $125 million once fully phased in. As the nation and Missourians age, the cost of HB 444 is only going to grow over time, making it more difficult to fund services that seniors (and everyone else) count on.

Alternatives

The Social Security tax cuts in House Bill 444 offer virtually nothing to most low-income retirees. This poorly targeted tax break shifts the cost of funding public services towards non-elderly taxpayers, many of whom are less well-off than the upper-income seniors benefitting from this exemption. Retooling Social Security exemptions to better target the neediest seniors will help Missouri, in the long run, to achieve a fairer and more sustainable tax system.

There are alternatives to providing tax cuts like those enacted in House Bill 444. Legislators interested in assisting poor and middle income seniors would do better to direct their attention to less expensive tax changes like expanding the state's property tax circuit breaker or introducing another type of means-tested targeted tax credit.