¶5055 RETIREMENT INCOME

Historically, Social Security benefits, both monthly and lump-sum, had been excluded from tax. The exclusion extended to benefits received under the Railroad Retirement Act. Benefits received from retirement systems of other countries are not excluded from the federal income tax.

A portion of the Social Security benefits or railroad retirement benefits must be included in taxable income for taxpayers whose provisional income exceeds a base of $25,000 for a single taxpayer ($32,000 for a married taxpayer filing a joint return and zero for a married person filing a separate return). Provisional income equals modified adjusted gross income plus one-half the Social Security benefits received. Modified adjusted gross means adjusted gross income plus interest on tax-exempt bonds, interest on U.S. savings bonds used to pay higher education tuition and fees, employer adoption assistance, the interest deduction on higher education loans, the deduction for qualified education expenses, and the foreign income exclusion. The amount of Social Security benefits includible in taxable income is the lesser of one-half of the benefits or one half of the excess of the taxpayer's provisional income over the base.

EXAMPLE 5.2

Bill and Linda Peterson, both over age 65, have the following sources of income:

Interest Income (taxable)	$26,000
Dividend Income	4,000
Net Rental Income	6,000
Adjusted Gross Income	$36,000
Social Security Benefits	$15,000
Computations:	
Adjusted Gross Income	$36,000
1/2 of Social Security Benefits	7,500
Provisional Income	$43,500
Base Amount for Married Couple	32,000
Excess	$11,500
50 Percent of Excess	$5,750

Of the $15,000 Bill and Linda received in Social Security benefits, they must include $5,750 in their gross income. Remember, the maximum amount to be included in gross income is the lesser of 50 percent of the "excess" or 50 percent of the Social Security benefit received.

Social Security benefits are taxable to the individual who receives the benefits. Therefore, if a child receives Social Security benefits, the benefits are taxable to the child using the same formulas that are discussed above.

The Revenue Reconciliation Act of 1993 created a second threshold for years after 1993. This second threshold applies to taxpayers with provisional income greater than $34,000 for a single taxpayer and $44,000 for a married taxpayer filing a joint return. Taxpayers with provisional income exceeding the second threshold will be taxed up to 85 percent of their Social Security benefits.

Taxpayers with provisional income exceeding these amounts will include the lesser of:

A. 85 percent of the taxpayer's Social Security benefits, or
B. the total of the following calculation:
   1. 85 percent of the amount that provisional income exceeds the new threshold amounts, plus
   2. the smaller of: (a) the amount of Social Security benefits included under prior law; or (b) $4,500 for an unmarried taxpayer, or $6,000 for married taxpayers filing jointly.

Married taxpayers filing separate returns have no base amount and must include in gross income the lesser of: (a) 85 percent of their Social Security benefits; or (b) 85 percent of their provisional income. For illustrations when provisional income exceeds the thresholds, see Examples 5.5 through 5.8.

EXAMPLE 5.3

Linda, a single taxpayer, has AGI of $26,000 and Social Security benefits of $8,000. Linda's provisional income is $30,000 and she must include in her AGI $2,500 of her Social Security benefits. Inasmuch as her provisional income is below the threshold amount ($34,000), she includes in AGI the lesser of 50 percent of her Social Security benefits or one-half the excess of combined income over the base.

EXAMPLE 5.4

Philip and Linda, a married couple filing a joint return, have AGI of $30,000 and Social Security benefits of $14,000. Therefore their provisional income is $37,000. Philip and Linda must include in their AGI $2,500 of their Social Security benefits. Inasmuch as provisional income, $37,000, does not exceed the threshold amount ($44,000), only $2,500 is included in the AGI of Philip and Linda.

EXAMPLE 5.5

Pat, a single taxpayer, has AGI of $36,000 and she received $10,000 in Social Security benefits. Pat's provisional income is therefore $41,000. Pat must include in her AGI $8,500 of her Social Security benefits. This is computed as follows:

A. $10,000 × 85% = $8,500
B. [($41,000 – $34,000) × 85%] + $4,500 = $10,450

EXAMPLE 5.6

Steve and Marla, a married couple filing a joint return, have AGI of $50,000 and Social Security benefits of $14,000. Steve and Marla have provisional income of $57,000. They must include $11,900 of their Social Security benefits in their gross income. This is computed as follows:

A. $14,000 × 85% = $11,900
B. [($57,000 – $44,000) × 85%] + $6,000 = $17,050

EXAMPLE 5.7

Ron, a single taxpayer, has AGI of $32,000 of income and $8,000 of Social Security benefits. Ron's provisional income is $36,000 and he must include $5,700 of his Social Security benefits in his income. This is computed as follows:

A. $8,000 × 85% = $6,800
B. [($36,000 – $34,000) × 85%] + $4,000* = $5,700
* $8,000 × 50% = $4,000 maximum includible under prior law

EXAMPLE 5.8

Norm and Pat, a married couple filing a joint return, have AGI of $40,000 and Social Security benefits of $12,000. Norm and Pat have provisional income of $46,000 and they must include $7,700 of Social Security benefits in their AGI. This is computed as follows:

A. $12,000 × 85% = $10,200
B. [($46,000 – $44,000) × 85%] + $6,000* = $7,700

* $12,000 × 50% = $6,000 maximum includible under prior law

EXAMPLE 5.9

Bill and Linda are married and file a joint return. They have $36,000 of AGI, $9,000 of tax-exempt interest and $15,000 of social security benefits. Bill and Linda have provisional income of $52,500 ($36,000 + $9,000 + $7,500). They must include $11,725 of social security benefits in their AGI. This is computed as follows:

A. $15,000 x 85% = $12,750
B. [($52,500 - $44,000) x 85%] + $4,500 = $11,725

¶5075 INTEREST ON GOVERNMENT OBLIGATIONS

Savings Bonds

Interest earned on United States savings bonds is fully taxable. On Series EE bonds, no interest per se is paid each year, but the bond is issued at a discount and each year increases in value until maturity. The difference between the purchase price of the bond and the redemption value is taxable interest income. Cash basis taxpayers have the choice of reporting interest income on a yearly basis or reporting all interest income when the bonds finally mature, while accrual basis taxpayers must accrue the increase in the redemption value each year as interest. If cash basis taxpayers exercise the election to report the interest currently, all such bonds owned by them must be similarly treated for all subsequent years.

Taxpayers who elected to defer recognizing income until the bonds mature may change their method of reporting income to a yearly basis without permission from the IRS. However, in the year of change all interest accrued to date, not previously reported, must be included in gross income.

Series EE bonds were first issued in 1980. Prior to 1980, Series E bonds were issued. Series HH bonds replaced Series H bonds in 1980, as well. Series HH and Series H bonds are treated identically for tax purposes. August 2004 was the last date that Series HH bonds were issued. After that date taxpayers were no longer able to reinvest series HH bonds or exchange series EE bonds for HH bonds. These bonds are issued at face value and interest is paid twice a year by check. Cash basis taxpayers must report interest income in the year it is received.

Taxpayers who owned Series E bonds prior to 1980 and did not report interest income on a yearly basis could trade their E bonds for Series H bonds and not realize taxable income unless they received cash on the trade. The same rules hold for Series EE bonds as for Series HH bonds today. On the E/EE bonds, the taxpayer defers the recognition of income until the taxpayer disposes of the bonds or they mature. Then the taxpayer reports as interest income the difference between the redemption value and the total cost of traded bonds, plus any amount received at the time of trade.

EXAMPLE 5.10

Robert and Mary Moore had the following interest income in 2021:

1. Interest on Series EE bonds, $300
2. Interest on bank savings account, $400

Robert and Mary have taxable interest income of $700. If they elect, they can defer the recognition of income on the Series EE bonds until the bonds mature. In that case, then total interest to be included in gross income totals $400.

Educational Savings Bonds

A tax exclusion is provided for interest earned on U.S. savings bonds used to finance the higher education of the taxpayer, the taxpayer's spouse, or dependents. Code Sec. 135. The bonds must have been purchased after December 31, 1989, and the exclusion is available only to the individual who purchased the bonds. The purchaser of the bonds must have reached the age of 24 and be the sole owner of the bonds. The bonds must be redeemed during the same tax year in which the qualified educational expenses are incurred by the taxpayer, the taxpayer's spouse, or any dependents.

Qualified higher education expenses include tuition and fees, net of scholarships and other tuition reduction amounts. Qualified higher education expenses must be further reduced by expenses taken into account for the American Opportunity Tax Credit and Lifetime Learning credits. Books, supplies, room and board and expenses incurred for sports, games, or hobbies other than as part of a degree program are not covered.

The key to computing the exclusion is the amount of qualified higher education expenses that the individual incurs in the year the bonds are redeemed. If these expenses exceed the aggregate redemption amount (principal plus interest), then all of the interest may be excluded, subject to an income-linked phase-out discussed below. If the redemption amount is larger than the qualified educational expenses, however, the exclusion is reduced on a pro rata basis.

EXAMPLE 5.11

During 2021, Mary Adams, age 50, redeems Series EE bonds and receives $5,000 of principal and $2,500 of accrued interest. Mary's daughter attends college and has qualified expenses of $8,000. Mary may exclude from her gross income the entire $2,500 of interest.

EXAMPLE 5.12

Same facts as in Example 5.11, except Mary's daughter incurred only $6,000 in qualified expenses. Mary may exclude from gross income only $2,000. This is calculated as follows:

$$\frac{\text{Qualified Expenses}}{\text{Series EE Proceeds}} = \text{Percentage Exclusion}$$

Percentage Exclusion × Series EE Interest = Interest Exclusion

Percentage Exclusion = $6,000/$7,500 = 80%

Interest Exclusion $2,500 × 80% = $2,000

The exclusion for accrued interest is subject to phaseout provisions. The phaseout ranges for 2021 are as follows:

Filing Status	Modified AGI
Married filing jointly	$124,800—$154,800
Single (including head of household)	$83,200—$98,200

Married individuals filing separately are not eligible for the exclusion.

For those falling within the phaseout range, the amount of interest otherwise excludable will be reduced (but not below zero) by multiplying that interest by a fraction that is determined by dividing the excess of modified AGI (that is, the excess of modified AGI over the bottom figure of the phaseout range) by the number of dollars in the phaseout range ($30,000 for joint returns and $15,000 for single taxpayers).

EXAMPLE 5.13

Same facts as in Example 5.11, but also assume that Mary is a single mother and that her modified AGI is $95,200. Mary may exclude from her gross income $500. This amount is computed as follows:

$2,500 – ($2,500 × $12,000/$15,000) = $500

The $12,000 is the excess of modified AGI over the phaseout range.

State and Municipal Bonds

Interest received on state and local government bonds is generally excludable from gross income. Code Sec. 103(a). The term "state or local bond" means an obligation of a state or political subdivision, and the term "state" includes the District of Columbia and any possession of the U.S. Code Sec. 103(c). Tax-exempt bonds are an attractive investment for many well-to-do investors because the after-tax return on such bonds is considerably higher than taxable bonds.