



Will Your Social Security Benefits Be Taxed -- Again?

By Bill Bischoff
October 16, 2007

THINK YOUR SOCIAL SECURITY benefits are always free from federal-income tax? Think again. In fact, depending on how much income you have from other sources, you may have to report up to 85% of your benefits on Form 1040 and pay the resulting federal income tax hit.

When this happens, you're effectively getting taxed twice on the same dollars. The first time is during your working years when you pay federal income taxes on Social Security taxes that are taken out of your salary or self-employment earnings. The second instance occurs later on when you have to pay federal income taxes on your Social Security benefits. To make matters worse, depending on where you live, you may suffer the same double taxation fate under your state income tax rules, too.

While this is unfair, if not downright scandalous, it's pretty much par for the course in the tax world. So here's what you need to know about the federal income tax bite on Social Security benefits. We've also included a handy-dandy calculator so you can quantify the financial damage for yourself. While the information may be painful to contemplate, it's better than blissfully assuming all your benefits will be tax-free when they won't.

Calculate Your Provisional Income

The amount of Social Security benefits that you must report as taxable income on your Form 1040 depends on how much "provisional income" you have for the year. To arrive at your provisional income, start with your adjusted gross income, or AGI, which is the amount that will appear on the last line on Page 1 of your Form 1040. However, don't count any Social Security benefits when figuring your AGI. (You can find a Form 1040 on the IRS web site here¹.)

Next, take that AGI number and add the following amounts (chances are, only the first two will apply to you).

1. 50% of your Social Security benefits.
2. Tax-free municipal bond interest income (from line 8b of Form 1040).
3. Tax-free interest on U.S. Savings Bonds used to pay for qualified college expenses (from IRS Form 8815).
4. Tax-free adoption assistance payments from your employer (from IRS Form 8839).
5. The Page 1 deduction for student-loan interest.
6. The Page 1 deduction for higher education tuition and related fees.
7. The Page 1 deduction for domestic production activities (from IRS Form 8903).
8. Tax-free foreign earned income and housing allowances and certain tax-free income from Puerto Rico or U.S. possessions (from IRS Forms 2555 and 4563).

The result of doing all this arithmetic is your provisional income for the year.

Find Your Tax Scenario

Now that you know your provisional income, you can determine which of the following three tax scenarios you fall under.

Scenario 1: All Your Benefits Are Tax-Free

If your provisional income is \$32,000 or less, and you will file a joint Form 1040 with your spouse, your Social Security benefits will be totally federal-income-tax-free (but you might still owe state income tax).

If your provisional income is \$25,000 or less, and you won't file jointly, the general rule is that your Social Security benefits will be totally federal-income-tax-free. (However, if you're married and file separately from your spouse who lived with you at any time during the year, you must report up to 85% of your Social Security benefits as income on Form 1040 unless your provisional income is zero or a negative number, which is unlikely.)

Having totally federal-income-tax-free benefits is nice, but, as you can see, this happy outcome is only allowed when your provisional income is relatively low.

Scenario 2: Up to 50% of Your Benefits Are Taxed

If your provisional income is between \$32,001 and \$44,000, and you will file a joint Form 1040 with your spouse, you must report up to 50% of your Social Security benefits as income on your Form 1040.

If your provisional income is between \$25,001 and \$34,000, and you won't file jointly, you must report up to 50% of your Social Security benefits as income on your Form 1040.

Scenario 3: Up to 85% of Your Benefits Are Taxed

If your provisional income is above \$44,000, and you will file a joint Form 1040 with your spouse, you must report up to 85% of your Social Security benefits as income on your Form 1040.

If your provisional income is above \$34,000, and you won't file jointly, the general rule is that you must report up to 85% of your Social Security benefits as income on your Form 1040.

As mentioned earlier, you also must report up to 85% if you're married and file separately from your spouse who lived with you at any time during the year — unless your provisional income is zero or a negative number, which would be rare.

Social Security Taxation Calculator

While you now understand which Social Security benefits taxation scenario you fall into, you still don't know exactly how much of your benefits must actually be reported as income on your return. Trust me when I say you don't want to learn all the sordid details about how to figure that out. Instead, just plug your numbers into our calculator, and let it do the crunching for you. Don't let the number of entry lines scare you. They will not all apply to you.

Social Security Taxation Calculator

Links in this article:

¹<http://www.irs.gov/pub/irs-pdf/f1040.pdf?portlet=3>

URL for this article:

<http://www.smartmoney.com/taxmatters/index.cfm?story=20071016>

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