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Report to the Chairman, Subcommittee on Oversight, Committee on Ways and Means, House of Representatives

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SOCIAL SECURITY

Trust Funds Can Be More Accurately Funded

GAO United States
General Accounting Office
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Health, Education, and
Human Services Division

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September 2, 1994

The Honorable J.J. Pickle
Chairman, Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

Dear Mr. Chairman:

This report responds to your request that we review several matters related to how unreported tax-exempt income affects the taxation of social security benefits. It also discusses how the Department of the Treasury, with the assistance of the Internal Revenue Service, determines the amount of revenue owed to the social security trust funds from the taxation of benefits. The report contains recommendations to Treasury and the Internal Revenue Service to improve the accuracy of the funding process.

We are sending copies of this report today to the Secretary of the Treasury, Commissioner of Internal Revenue, and the Commissioner of Social Security. We are also providing copies to the Director, Office of Management and Budget, and interested congressional committees. Copies will be made available to others upon request.

Major contributors to this report are listed in appendix IV. If you have any questions, please call me at (202) 512-7215.

Sincerely yours,

Joseph F. Delfico

Joseph F. Delfico
Director, Income Security Issues

Executive Summary

Each year, the social security trust funds are credited with revenues derived from income taxes paid on social security benefits. But do they get the right amount? GAO examined how the Department of the Treasury and the Internal Revenue Service (IRS) ensure that the trust funds receive the revenues due from taxing social security benefits. After work began, the House Ways and Means Committee's Subcommittee on Oversight asked GAO to pursue several related questions that are also addressed in this report.

Background

Social security benefits became subject to income taxes beginning in 1984. When the Congress made benefits taxable, it decided that the revenues derived from the tax should be credited to the social security trust funds to strengthen their long-term solvency. Under the tax provision, taxable gross income for social security beneficiaries must include up to one-half of their social security benefits when their income exceeds certain thresholds: $32,000 for a married couple filing jointly and $25,000 for single individuals and married persons who live apart at all times during the tax year. The threshold is zero dollars for married persons filing separately who live with their spouses at any time during the year. The amount of social security benefits to be included in a taxpayer's income is determined by totaling their (1) adjusted gross income, (2) interest from tax-exempt sources, and (3) one-half of their social security benefits. The total of these three amounts is then compared to the appropriate threshold. If their income exceeds the relevant threshold, the taxpayer must include in taxable gross income the lesser of one-half of their social security benefits or one-half of the excess of their income over the threshold.

From 1984 through 1991, Treasury credited about $29 billion from taxed social security benefits to the trust funds. The amount of taxes transferred to the trust funds rose over the years from about $2.1 billion in 1984 to over $5.9 billion in 1991. For several reasons, this revenue source will take on greater significance in the future as several factors combine to make even more benefit dollars taxable.

First, the Congress did not index the income thresholds that must be met before benefits are taxed. As a result, a growing percentage of social security recipients will have their benefits taxed as their income levels rise from inflation and growth in real wages.

Second, the number of beneficiaries has continued to grow since benefits became taxable. In 1984, the Social Security Administration (SSA) was paying benefits to about 36.5 million beneficiaries. By the year 2005, it will pay benefits to an estimated 50 million persons. With the retirement of the baby boom generation beginning around the year 2010, the beneficiary rolls will grow even more rapidly. This increasing number of beneficiaries will be paid increasing amounts of benefits that will be taxable.

Finally, new legislation will greatly increase the amount of benefits subject to tax. Beginning in 1994, the maximum proportion of social security benefits subject to income tax will increase from 50 to 85 percent. The higher maximum tax rate applies to those beneficiaries with incomes over an additional set of thresholds: $34,000 for single and $44,000 for jointly filed tax returns. The additional revenues from this new legislation are to be credited to the Hospital Insurance trust fund.

Results in Brief

The social security trust funds' revenues could be increased by recognizing additional taxes identified through IRS' efforts to locate underreported taxable income and by better detection of underreported tax-exempt interest.

When Treasury adjusts the quarterly advances made to the trust funds to reflect actual tax liabilities, it does not consider the results of IRS assessing additional taxes on benefits when it identifies underreported income through its information-matching program. Recognizing these additional taxes could have increased the trust funds by more than $200 million in tax revenue and investment income for tax years 1984 to 1989.

In addition, because IRS does not receive reports from payers of tax-exempt income, it cannot routinely detect underreported amounts that could affect taxes owed. Tax-exempt income must be considered when beneficiaries determine how much of their benefits are taxable. This type of income is often earned by social security beneficiaries. Comparison of tax-exempt income reported on tax returns with earnings estimates developed using data from the Federal Reserve and the Investment Company Institute indicates that taxpayers may have underreported an estimated $7.2 billion in tax-exempt income on their 1989 tax returns. However, tax-exempt income only affects taxes for certain taxpayers, and data are not available to determine how much additional tax may result from reporting all tax-exempt income.

Principal Findings

Revenues From Audits Not Credited

The Treasury collects federal taxes and manages the investment of revenues for the social security trust funds. It advances revenues to the trust funds each quarter based on its estimate of individual income tax liabilities related to social security benefits. Adjustments to correct errors in estimating are made after tax returns have been filed and processed.

Treasury's adjustments are based on the actual social security benefit tax liabilities reported to IRS on individual tax returns. Basically, IRS calculates what the income tax liability for each taxpayer would have been if their social security benefits had not been taxable. The difference between the tax liabilities reported on tax returns and the recalculated tax liabilities represents the amount of revenue attributable to taxing benefits.

Treasury's methodology for estimating and transferring revenues from taxed benefits to the trust funds does not consider the results of IRS' underreporter tax compliance program. In the underreporter program, IRS verifies that taxpayers properly recognized their taxable income by comparing tax returns with information returns (separate reports of income it has received from the payers of that income). One of the comparisons IRS makes is to determine whether taxpayers recognized taxable social security benefits on their returns.

For tax years 1984 to 1989, IRS assessed additional taxes, interest, and penalties of about $225 million against 340,000 taxpayers whose social security benefits were the primary underreporting issue. Limitations of IRS' accounting system make it impossible to identify how much of that amount was just for underpaid taxes on benefits. Under the law, Treasury shall adjust the amount transferred to the trust funds to recognize the additional taxes assessed.

Controls Are Weak

Social security recipients must add their tax-exempt interest income to their adjusted gross income to determine how much of their benefits are subject to income tax. IRS cannot verify that taxpayers are properly making this calculation because it does not receive an information return from paying institutions for this type of income. Without that information, the effectiveness of its underreporter program in administering the tax on benefits is diminished.

Third party information returns are a fundamental control in tax administration. With them IRS can detect underreported income and assess additional taxes. GAO compared aggregate data from the Federal Reserve and Investment Company Institute on household investments in tax-exempt securities with reports of this income on tax returns. The comparison indicates that taxpayers may not have reported about $7.2 billion in tax-exempt interest in 1989.

How this affected tax revenue from social security benefits cannot be accurately determined because tax-exempt income only affects the taxes of some taxpayers. The revenue implications of this control weakness will be greater in the future because of (1) a greater proportion of benefits being subject to tax, (2) dramatic growth in the number of persons who will be getting benefits, and (3) the interaction of inflationary pressures on benefit levels with the static income thresholds that make benefits taxable.

Establishing this additional control would entail incremental costs. IRS estimated that its additional processing costs would be about 20 cents for each new information return. These costs can be mitigated by reporting tax-exempt interest as an additional item on an existing information return.

Representatives from the financial services industry did not favor reporting tax-exempt income to IRS. They said that reporting earnings from unregistered and original issue discount bonds (about 10 percent of the tax-exempt market) would be very difficult because the industry lacks the information needed for reporting. They acknowledged that reporting tax-exempt income to IRS would improve tax compliance. However, they said that because tax-exempt income affects the tax liability of only some taxpayers, it would be burdensome to the industry to report the earnings for all investors.

GAO believes the reporting burden can be mitigated. The industry already reports earnings to investors in registered securities. It simply does not give IRS a copy. Also, reporting tax-exempt earnings as a distinct item on an existing information return, rather than requiring a separate return for tax-exempt income, would lessen the reporting burden.

Recommendations

To more accurately credit the social security trust funds with revenues from taxing benefits, GAO recommends that Treasury revise its process for adjusting the advances to the trust funds to recognize the additional tax liabilities assessed because of IRS detection of underreported taxes due on social security benefits. GAO also recommends that IRS conduct a pilot test to better estimate the benefits and costs of reporting tax-exempt income. If cost-beneficial, IRS should take appropriate steps to routinely acquire this information.

Agency Comments

The Commissioners of Social Security and Internal Revenue and Treasury's Office of Tax Analysis (OTA) provided written comments on a draft of this report. The Commissioner of Social Security fully agreed with the recommendations. She said that with the number of individuals entitled to benefits growing each year, it is imperative that amounts credited to the trust funds accurately reflect all social security taxes. (See pp. 17 and 28.)

OTA said that it is aware that IRS can identify certain amounts of additional income taxes owed because of the underreporting of social security benefits. It concluded, however, that no additional transfers to the social security trust funds should be made for underreported tax liability on social security benefits until that liability can be more precisely measured. GAO disagrees and believes it is important and feasible to pursue solutions to this funding issue. (See pp. 17 and 18.)

The Commissioner of Internal Revenue said that IRS is interested in measuring the extent to which taxpayers are complying with the tax on social security benefits, particularly with the major changes in the amount of benefits taxable beginning in 1994. She indicated that IRS will use its 1994 Taxpayer Compliance Measurement Program as a vehicle to study compliance levels related to the underreporting of tax-exempt interest. (See p. 28.)

Contents

Abbreviations

ICI	Investment Company Institute
IRS	Internal Revenue Service
OID	original issue discount
OTA	Office of Tax Analysis
SOI	Statistics of Income
SSA	Social Security Administration
TCMP	Taxpayer Compliance Measurement Program

Introduction

The Social Security Administration (SSA) paid about $290 billion in benefits to more than 40 million individuals in 1992. Since 1984, when beneficiaries' income exceeds specified levels, a portion of their benefits has been taxable. The Department of the Treasury collects the revenue from taxable benefits and distributes it to the social security trust funds.[1]

Between 1984 and 1991, over $29 billion from income taxes on social security benefits has been credited to the trust funds. We examined how Treasury administers this tax and its method for determining the amount of tax revenues owed to the trust funds. Also, at the request of the House Subcommittee on Oversight, we considered the effect of unreported tax-exempt interest on taxes owed by social security beneficiaries.

History of Benefit Taxation

When the Social Security Act was enacted in 1935, it did not address the income tax treatment of social security benefits. In 1938 and 1941, Treasury's Internal Revenue Service (IRS) (known then as the Bureau of Internal Revenue) issued several administrative rulings that concluded that program benefits would not be taxable. Essentially, the rulings said that social security benefits were like gifts, made to aid the general public welfare. Thus, taxing benefits would defeat the underlying purposes of the Social Security Act.

In the late 1970s and early 1980s, the financial condition of the social security trust funds, which finance program operations, had greatly deteriorated. In 1975, program expenditures began to exceed annual tax revenues for the first time. It was predicted that unless remedial action was taken, the Social Security system would be unable to pay benefits on time after July 1983.

To deal with the program's financial crisis, the Congress enacted the Social Security Amendments of 1983. The amendments required a number of actions that reduced expenditures and increased revenues as a way to correct the trust funds' solvency problem. One of the revenue enhancement provisions of the amendments made a person's social security benefits taxable when specified income thresholds were

[1]Revenues are credited to the Federal Old-Age and Survivors Insurance, Federal Disability Insurance, and Social Security Equivalent Benefit Account (Railroad Retirement) trust funds. Beginning with tax year 1994, the Federal Hospital Insurance Trust Fund will also receive certain revenues from taxable benefits.

exceeded. The Congress mandated that the revenues from this tax be returned to the social security trust funds.[2]

The taxing of social security benefits was designed to be a significant source of income to correct the financial problems of the trust funds. It was estimated that taxing benefits would generate 26 percent of the revenues needed to resolve Social Security's long-term financial problems.

How the Tax Is Administered

Treasury is responsible for the government's financial operations. In regard to the tax on social security benefits, Treasury is required to (1) make quarterly estimates of individual income tax liabilities attributable to the benefits paid and (2) transfer these estimated amounts to the trust funds. Subsequently, Treasury uses actual tax return data to correct estimating errors.

Treasury's Office of Tax Analysis (OTA) is responsible for making the estimates and authorizing the adjustments to the trust funds. IRS administers the federal income tax system and assists OTA by providing actual tax return data.

Objectives, Scope, and Methodology

We began this assignment with the primary objective of examining the methods Treasury uses to estimate the transfer of tax revenue from social security benefits to the trust funds. In addition, we wanted to review how Treasury ensures that taxpayers properly recognize their tax liability for benefits and credits the trust funds with associated tax revenues.

Subsequently, the House Ways and Means Subcommittee on Oversight asked us to pursue several issues related to tax-exempt income that must be considered in determining the amount of benefits subject to tax. Specifically, we were asked to determine (1) to what extent unreported tax-exempt income results in avoidance of the tax on social security benefits; (2) whether this is an area where an increase in the amount of tax revenues lost because of underreported income is to be expected; and (3) what additional compliance measures would improve IRS' ability to properly assess and collect the tax on social security benefits.

We met with officials of OTA and IRS at their headquarters offices in Washington, D.C. We also held meetings with representatives of IRS'

[2]For an in-depth discussion of the history and issues related to taxation of social security benefits, see Social Security: Issues in Taxing Benefits Under Current Law and Under Proposals to Tax a Greater Share of Benefits, Congressional Research Service Report for Congress (89-40 EPW, Jan. 12, 1989).

regional and district offices in Philadelphia and with officials at SSA headquarters in Baltimore. Additionally, we discussed aspects of this issue with officials from the Federal Reserve's Office of Statistics, the Bureau of the Census' Office of Statistical Research, and the National Bureau of Economic Research. We held discussions and meetings with representatives from the private sector, including associations such as the Public Securities Association and the Depository Trust Corporation in New York City. We also held a roundtable discussion with business leaders who represented segments of the financial services industry (banking, investment brokers, mutual fund managers, paying and enrolled agents).

To identify revenue related to taxable social security benefits, we reviewed and analyzed statistical information and computer files on tax returns from IRS. This assignment was conducted between March 1993 and February 1994 in accordance with generally accepted government auditing standards.

Treasury Should Credit Trust Funds With Additional Revenues From Taxed Benefits

The social security trust funds are not credited with all revenues from income taxes on social security benefits. In determining how much revenue is owed to the trust funds from taxing benefits, Treasury does not consider additional taxes that result from IRS assessments against taxpayers underreporting their income on individual returns. Shortcomings in IRS' accounting system make it difficult to precisely measure the revenue not credited to the trust funds. However, the best available data indicate that the trust funds may have lost an average of $37 million per year in additional taxes from 1984 to 1989 (more than $200 million for just these tax years).[3] Under the law, Treasury should consider these additional taxes on benefits when it credits the trust funds.

Trust Funds Should Be Credited for Assessed Taxes

The 1983 Social Security Amendments require Treasury to transfer to the trust funds "amounts equivalent to the aggregate increase in tax liabilities" attributable to the taxation of social security benefits. Each quarter, Treasury estimates the income tax revenues attributable to taxable social security benefits and credits this estimated amount to the social security trust funds. These estimates are made using a tax model developed by Treasury's OTA.

Very briefly, this model uses as its basis IRS' Statistics of Income (SOI) data from 1985.[4] The data are extrapolated to recent years based on several types of growth projections and the model has a "tax calculator" to compute changes in tax liabilities over time. These calculations are then weighted to represent the universe of taxpayers. The model also employs certain other information from SSA and the Census Bureau that allows estimates of taxable SSA income to be distributed among appropriate groups of taxpayers.[5]

With IRS' assistance, Treasury annually adjusts estimated amounts transferred to the social security trust funds based on actual tax returns. First, IRS calculates the income tax liabilities from all the individual returns that had social security benefits included in adjusted gross income. For these returns, IRS calculates what the income tax liabilities would have

[3]Because of lags between the time returns are filed and the time they are audited, data on assessments for later years were not available.

[4]The SOI file shows aggregate tax return data for each line item on tax returns. The data (number of returns and amount of dollars reported) are stratified by income levels of taxpayers. The data are developed from analyses of randomly selected tax returns. The sample is used to project overall tax data on a national level.

[5]A detailed description of Treasury's methodology for estimating benefit taxation is in its annual report to the Congress, Report on the Taxation of Social Security and Railroad Retirement Benefits.

been if social security benefits were excluded from adjusted gross income. The difference between tax liabilities of the two calculations is the amount of tax revenue attributable to taxing social security benefits.

The amount of the adjustment is determined by comparing the previously transferred estimated amount for the tax year to IRS' actual calculation of revenues from the taxing of benefits. Treasury's method for crediting revenue to the trust funds is permissible under the act.[6] However, it does not consider additional tax liabilities that IRS assesses on social security benefits after examining filed tax returns through its underreporter program.

IRS' underreporter program is a comprehensive electronic examination of all tax returns. IRS matches available information returns—independent reports of income filed by payers of that income—with income that individuals reported on their tax returns. The purpose of these matches is to ensure that taxpayers recognize all taxable income on their returns. In cases where unreported income is discovered, IRS attempts to resolve discrepancies. Ultimately IRS assesses taxes and may also assess penalties and interest on taxpayers who have underpaid taxes.

Among the many matches that IRS makes in its underreporter program is a comparison of the amount of benefits that SSA reported to it against the individual tax returns of social security beneficiaries. During the period from 1984 to 1989, IRS identified almost 340,000 social security beneficiaries who underreported the amount of their social security benefits subject to income tax. As shown in table 2.1, IRS assessed about $225 million in additional taxes, penalties, and interest on taxpayers in cases where social security was considered the primary issue in dispute.

[6]The act does not specify how Treasury is to make the adjustment in amounts credited to the trust funds. However, in the legislative history of the provision, the Senate Finance Committee stated: "A final determination of the amount required to be transferred for a year may [underscoring supplied for emphasis] be based on an estimate derived from the appropriately weighted sample of individual income tax returns for that year...."

Table 2.1: Potential Increased Trust Fund Revenue Based on Results of IRS Tax Assessments for Underreported Income

Dollars in millions

Tax year	From cases where social security benefits are the primary issue	Potential cumulative trust fund increase
1984	$44.9	$44.9
1985	33.5	78.4
1986	33.0	111.4
1987	35.0	146.4
1988	42.6	189.0
1989	35.7	224.7

Source: IRS tax assessment data from its underreporter program.

It is important to understand that table 2.1 estimates the potential increases in trust fund revenues for 1984 through 1989 that would have resulted if Treasury's process recognized IRS assessments for underreported taxable benefits. Several factors make it impossible to determine the precision of this estimate from available data.

First, IRS does not precisely track additional tax assessments by the many different elements of income and deductible expenses that a tax return comprises. When it detects multiple problems involving the underreporting of income on a tax return, IRS attributes any additional tax assessment to the primary element where a reporting problem was detected. Thus, a portion of the $225 million may represent assessments not related to social security benefits. Likewise, other assessments for underreported taxable benefits probably have been made, but cannot be identified because these cases are associated with a different primary issue. Table 2.1 assumes that these factors cancel each other.

Second, IRS cannot determine how much of the $225 million in assessments is for unpaid taxes versus interest and penalties. This distinction is important because the trust funds are only entitled to revenues from the assessments for unpaid taxes. This limitation tends to overstate the estimated trust fund losses. However, table 2.1 reduces the overstatement to some degree because it ignores the investment income that the trust funds lost by not having access to these revenues. In effect, the table assumes that the interest charged for underpaid taxes is roughly equivalent to the lost investment opportunity. Thus, only the penalty portion of the assessments remains unaccounted for.

Third, IRS statistics on assessments may not reflect the final outcome of the assessments. Taxpayers receiving assessment notices have an opportunity to explain to IRS that a mistake has been made.

One way to deal with these shortcomings in IRS' accounting system would be to examine a representative sample of cases that are assessed additional taxes. From such a sample, a ratio could be developed to determine the amount of assessments related to just unpaid taxes on benefits. This ratio could be used to allocate assessments from the underreporter program to the trust funds. There may be other methods that IRS can explore to estimate how much of the assessments from underreporting taxable social security benefits are owed to the trust funds.

We discussed with Treasury officials why no consideration was given to IRS assessments for underreported taxable benefits when it makes adjustments to the estimated amounts transferred to the trust funds. The officials told us that Treasury was not aware that IRS had sufficient information to identify the amount of additional taxes assessed on social security benefits.

Conclusion

The social security trust funds are not being credited with all revenues related to the taxing of social security benefits. The trust funds are not receiving revenues derived from the assessment of taxes resulting from the underreporting of income that affects the amount of taxpayers' taxable benefits. Although the current accounting approach is not inconsistent with the legislative history, Treasury can add assessments of additional tax liabilities identified by IRS when it examines tax returns. Considering these assessments would provide a better accounting of revenues owed to the trust funds.

Limitations in IRS' accounting system preclude a precise determination of additional taxes assessed for underreported taxable benefits. However, Treasury can do more to improve trust fund accountability by crediting the trust funds for this source of tax revenues. Revising Treasury's method for crediting the trust funds to consider assessments for unpaid taxes on benefits could have increased the trust funds' receipts by over $200 million for just tax years 1984 through 1989. The impact on the trust funds will continue to grow and compound until action is taken to recognize the additional revenues derived from the assessment of taxes on underreported taxable benefits.

Recommendation

We recommend that the Secretary of the Treasury direct IRS to identify the amount of additional taxes that have been assessed on social security benefits through its underreporter program. Treasury should use this information to revise its methodology for transferring to the trust funds revenues derived from taxing social security benefits.

Agency Comments

The Commissioner of Social Security and the Director, Office of Tax Analysis, at Treasury commented on this matter.

The Commissioner of Social Security stated that she concurred with our recommendation and added that this flaw in procedures should be corrected as soon as possible (see app. III). SSA also noted that Treasury should work with IRS to determine the best estimate of undercrediting of the trust funds for prior tax years and transfer these amounts (including interest lost on trust fund investments). If a reasonable estimate of the prior-year losses can be developed, we agree that the trust funds should be reimbursed for any revenues they lost under the prior approach.

OTA said that it is aware that IRS can identify certain amounts of income taxes owed because of the underreporting of social security benefits (see app. II). However, OTA suggested that no additional transfers of revenue be made until the liability can be determined more precisely. OTA cited the limitations with IRS data, which we discussed in the chapter, as the basis for its conclusion.[7]

Although we believe it would be preferable to have precise data to make this adjustment, precise data do not presently exist. Furthermore, IRS would probably have to make significant and costly changes in its accounting system to develop precise data. However, we do not believe the current limitations in the underreporting data suggest that the known funding problem should remain unresolved. Solutions can be pursued.

As noted on page 16, one approach would be for IRS to examine a representative sample of cases where IRS discovered underreported social security tax liabilities. Analysis of these cases would identify characteristics such as

[7]Essentially the limitations refer to the inability to determine how much of the assessments from the underreporter program where social security benefits are the primary underreporting issue is for just underreported taxes on benefits. As discussed in the chapter, the amount that IRS assessed also may include interest and penalties for underreporting and taxes assessed for underreporting other types of income.

- the proportion of the assessments that involved underreporting of income related only to social security benefits;
- the proportion of the assessments in the sample of cases related to just social security tax liability versus interest and penalties; and
- the proportion of the tax assessments abated by IRS.

Statistical sampling is a widely accepted analytical technique that can give reliable estimates of the true occurrence of events in a population. Answers to questions such as these can be used to estimate, within acceptable ranges of estimating error, the amount of additional tax liability IRS discovers in its underreporter program that affects social security tax liabilities.

We recognize that this approach has its limitations and is not the ideal solution. However, in our opinion, it is a reasonable approach to resolve a known problem that may have cost the trust funds $225 million over the period from 1984 to 1989. It must be remembered that the Congress intended to provide revenue from taxing social security benefits to the trust funds, not the general fund. Under the current situation, this intent is not being adequately fulfilled.

Finally, OTA stated that the report suggests overcoming the underreporter program data limitations by assuming that the interest charged for underpaid taxes is roughly equivalent to the lost investment opportunity. OTA's comment refers to a section in the chapter where we estimated the revenue lost to the trust funds because IRS tax assessments for underreported tax liabilities for social security benefits were not considered. Our intent, however, was simply to present a reasonable estimate of the losses to the trust fund, not to propose that the estimating method we used be adopted for official use.

Controls to Collect Taxes on Benefits Can Be Strengthened

Legal limitations preclude IRS from maximizing the use of one of its most valuable controls to ensure the accurate payment of taxes on social security benefits. IRS does not receive independent reports of the amount of tax-exempt interest that individuals earn. Yet, tax-exempt income, often earned by social security beneficiaries, must be counted when determining how much of a taxpayer's benefits are subject to income taxes.

Comparing various sources of aggregate data on tax-exempt income with earnings reported on tax returns indicates that taxpayers underreported about $7.2 billion in tax-exempt income in 1989. However, the lack of information on individual tax-exempt earnings, coupled with the fact that tax-exempt income does not affect everyone's tax liability, makes it very difficult to estimate the amount of tax revenues lost to the trust funds.

Without better information on tax-exempt earnings, equitable administration of the tax on social security benefits is not ensured. With dramatic growth expected in the number of persons paying tax on their benefits and the amount of benefits taxable, the significance of the problem and annual trust fund losses will likely grow in the future.

How Taxpayers Determine the Amount of Benefits Taxable

Taxpayers have to go through two basic steps to determine the amount of their social security benefits subject to income tax. First, they must determine if their "countable income" exceeds one of three income thresholds based on their tax-filing status.[8] Since 1984, these thresholds have been $32,000 for a joint tax return and $25,000 for persons who file as single, head of household, or qualifying widow(er), or who are married but living separately during the entire year. The threshold is zero dollars for persons who are married, living together for any part of the year, and filing separate returns.

If countable income does not exceed the applicable income threshold, no portion of a taxpayer's social security benefits is taxable. However, if countable income exceeds the threshold, a portion of their social security benefits becomes taxable. The taxable amount is the lesser of (1) 50 percent of the taxpayer's benefits or (2) 50 percent of the countable income that exceeds the income threshold.[9]

[8]Countable income is calculated by adding tax-exempt income and half of a taxpayer's social security benefits to adjusted gross income.

[9]In 1993, the Congress increased the proportion of benefits subject to taxation under certain conditions. The details of this change are discussed later in this chapter (see pp. 25-26).

Table 3.1 demonstrates how this threshold and tax calculation operate for three different income situations related to joint tax returns. In each case, the taxpayers are assumed to have $16,000 in annual social security benefits. We have varied other aspects of their income to show how much of their benefits must be included in their adjusted gross income.

Table 3.1: Examples of How Taxpayers Establish the Amount of Their Benefits Subject to Income Tax

Tax item	Taxpayer 1 Benefits not taxable	Taxpayer 2 Less than half of benefits taxable	Taxpayer 3 Half of benefits taxable
Adjusted gross income (before threshold test)	$20,000	$27,000	$48,000
Tax-exempt interest income	$1,000	$2,000	$4,000
Half of social security benefits	$8,000	$8,000	$8,000
Countable income	$29,000	$37,000	$60,000
Threshold for joint return	$32,000	$32,000	$32,000
Excess over threshold	$0	$5,000	$28,000
Benefits taxable (lesser of half of benefits or half of excess over threshold)	$0	$2,500	$8,000
Percent of total benefits taxable	0	15.6	50

IRS Lacks a Control to Routinely Detect Underreported Tax-Exempt Interest

Detecting unreported income is one of IRS' fundamental goals in tax administration. Information returns, independent reports of income that taxpayers and IRS receive from payers of the income, are one of IRS' most valuable controls to detect underreported income. By matching income reported on information returns with tax returns, IRS identifies millions of taxpayers that may have underreported income. For example, in 1987 IRS identified almost 18 million potential underreporters. More than 6 million of these cases were sent to IRS tax examiners and about $1.2 billion in additional taxes, interest, and penalties were assessed.

IRS does not require information reporting with respect to tax-exempt interest. Although tax statutes require information returns be filed for many types of income such as wages, dividends, tax refunds, and interest, IRS explained that tax-exempt interest is specifically exempted from reporting under one tax statute. And, by long-standing administrative ruling, IRS has not required the reporting of tax-exempt income under another tax statute that grants it broad authority to require the reporting of income equal to $600 or more.

After social security benefits became taxable, IRS revised tax returns to provide space for taxpayers to voluntarily report the amount of their tax-exempt income. For tax year 1989, individuals reported receiving about $37.6 billion in tax-exempt interest on their tax returns.[10]

Although $37.6 billion in tax-exempt income was reported on tax returns, IRS has no way to determine if this is the total amount of tax-exempt income earned by taxpayers.[11] We compared reported tax-exempt earnings on 1989 returns with various other sources of data on this type of income maintained by the Federal Reserve and the Investment Company Institute (ICI). Although these bodies have some data on tax-exempt earnings, the data are built to varying degrees on surveys and estimates. As a result, precise data on tax-exempt investments and tax-exempt income are unavailable.

The Federal Reserve data identify direct investment by households in tax-exempt securities. But the data cannot distinguish between institutional and household investment in tax-exempt securities invested through mutual and money market funds.

ICI's data are developed from voluntary reports by its membership, which accounts for about 95 percent of the industry assets invested in all types of mutual funds. However, when ICI surveys its members to gather data on investment holdings, not all of its members respond. For example, in 1989 ICI members holding only 63.8 and 73.4 percent of the accounts in money market and short-term municipal bond funds, respectively, reported to ICI. ICI extrapolated these data to prepare its investment data.

Using a combination of these data, an estimate of tax-exempt income earned by households can be made. Table 3.2 estimates that about $7.2 billion in tax-exempt interest was underreported. We do not know how precise this estimate may be because of the very limited reporting of data on tax-exempt income. For example, given the error associated with the IRS estimate, the amount of underreported tax-exempt interest ranged from $6.2 billion to $8.2 billion. Additional variation in the estimate results

[10]At the time of our review, tax year 1989 was the most recent year for which complete SOI data on filing were available.

[11]The IRS data for reported tax-exempt income are developed from its SOI file. SOI data are based on stratified probability samples of about 100,000 income tax returns filed with IRS. Being based on samples, SOI data are subject to a range of error at a given confidence level. The $37.6 billion in tax-exempt income has a $\pm$2.8 percent error rate at the 95-percent level of confidence. Thus, IRS is 95-percent certain that the true value of reported tax-exempt interest lies between $36.6 billion and $38.6 billion.

from uncertainty associated with the Federal Reserve and ICI data and the average interest rate we applied.

Table 3.2: GAO Estimate of Underreported Tax-Exempt Interest in Tax Year 1989

Dollars in billions

Aggregate household investment in tax-exempt securities[a]	
Direct holdings	$495.8
Mutual fund & money market holdings	135.6
Total holdings	**$631.4**
Average interest rate[b]	7.1%
Estimated tax-exempt household income	$44.8
IRS estimate of reported tax-exempt income	$37.6 (±$1)
Estimated unreported tax-exempt income	$7.2 (±$1)

[a]The aggregate data on investments combine information from the Federal Reserve (direct holdings) and ICI (mutual funds and money market holdings). In addition, direct household investments represents an average investment amount for the year. It was developed by averaging year-end values for the stated categories for 1988 and 1989. This average understates the value of tax-exempt securities because in 1988 the Federal Reserve data did not include the value of certain tax-exempt bonds. Also, some of these data were developed through sampling of issuances at the local level. Thus, the estimate of aggregate household investment is subject to error. Because of the nature of the data, however, we do not have sufficient information to calculate the range of error.

[b]The 7.1-percent interest rate was obtained from the Public Securities Association. The association represents brokers and underwriters who deal in municipal investments. It developed the interest rate from data prepared by Moody's Investor Services, Inc.

Source: Statistics of Income Individual Income Tax Returns 1989; Flow of Funds Accounts, Federal Reserve System, ICI (Mar. 1992); and Moody's Investor Services, Inc.

What Effect Does the Lack of an Information Return Have?

Institutions are not required to submit information returns to report the tax-exempt income they pay to investors. Consequently, important information needed to reliably estimate the revenue the trust funds lose because of underreported tax-exempt income is not available. For example, SOI data indicate that social security beneficiaries often receive tax-exempt income. In 1989, about 60 percent of the reported tax-exempt income was earned by taxpayers receiving social security benefits. However, it is not known if the underreported tax-exempt income goes to

- social security beneficiaries who may have an incentive to underreport because their tax-exempt income could place them over the taxing threshold,

- beneficiaries whose income is already high enough to make their benefits fully taxable without considering tax-exempt income, or
- persons not affected by the tax.

Only underreported tax-exempt income earned by social security beneficiaries whose taxes would be increased would raise trust fund revenues. We are unable, however, to reliably estimate the revenue losses from underreporting of tax-exempt income by this group. The information is not available to determine the portion of all underreporting attributable to this group as a whole and then reliably distribute amounts of the underreported income among individual taxpayers.

Beyond the revenue implications, questions of tax equity are also associated with this shortfall in IRS' controls. Tax-exempt interest was made an element in the tax calculation to ensure equitable treatment among social security beneficiaries. The intent was to prevent wealthier beneficiaries from avoiding the tax on their benefits by investing in tax-exempt securities.

With an information return for tax-exempt interest, IRS could be more certain that taxpayers are accurately determining how much of their social security benefits is taxable. Taxpayers who invest in tax-exempt securities would be less able to escape taxes on their benefits. Presently, it is only through costly detailed audits, which are limited in number, that IRS can identify some taxpayers who are not reporting tax-exempt interest.

Several Factors Will Cause Revenue Losses to Grow in the Future

The most compelling reasons for requiring information returns for tax-exempt income relate to the inevitable growth in the amount of benefit dollars that will be taxable in the near future. In the coming years, the amount of benefits subject to tax and the proportion of social security beneficiaries paying income taxes on their benefits will greatly increase. The increase is attributable to several factors:

- the structure of the tax on social security benefits coupled with the way benefit amounts are calculated,
- the anticipated significant growth in the beneficiary population, and
- a recent legislative change to the tax calculation that exposes a greater amount of benefits to income tax.

Effect of Wage and Income Growth on Taxing Social Security Benefits

A growing proportion of beneficiaries is having to pay income tax on their benefits. This is occurring because of the interaction of inflation and real wage growth with the method for calculating the taxable benefits.

Workers' annual wages and the amount of annual wages covered under the social security programs are increasing. Consequently, future retirees will receive higher benefit amounts reflecting these higher average lifetime earnings, which are the basis of their social security benefit amount. Likewise, current beneficiaries receive annual cost of living increases to adjust for inflation, which result in progressively higher benefits.

The Congress did not, however, index the income thresholds that must be met to make social security benefits taxable. Consequently, an increasing proportion of beneficiaries has modified adjusted gross incomes that exceed the static income thresholds. For example, in 1987 the Congressional Budget Office estimated that 14 percent of the beneficiaries paid taxes on their benefits. Our analysis shows that in 1989 about 20 percent of the beneficiaries paid taxes on their benefits.

Effect of Retired Population Growth

The aging of the nation's population also compounds the potential revenue consequences. The number of beneficiaries is expected to double over the next 40 years, primarily because of the retirement of the baby boom generation (persons born between the end of World War II and the mid-1960s). Around the year 2010, the baby boom generation will begin reaching retirement age. The number of beneficiaries will increase by millions at this time and billions more in benefit dollars will become taxable.

Beyond exposing more benefit dollars to the tax, this dramatic growth in the beneficiary population will also greatly increase the importance of the tax as a program revenue source. Program operations are primarily supported by the taxes workers and their employers pay on wages. With the baby boom generation in retirement, the ratio of workers to beneficiaries is expected to drop. This means that revenue derived from the tax on benefits will play a larger role in meeting existing program obligations. Table 3.3 shows the expected changes in number of beneficiaries, benefits paid, and worker-to-beneficiary ratios over the next 75 years.

Table 3.3: Growth in Beneficiaries and Benefits Paid, 1993-2070

Calendar year	Covered workers (millions)	Beneficiaries (millions)	Worker-to-beneficiary ratio	Total benefits (billions)[a]
1993	135.0	41.9	3.2	$ 309.1
1995	139.0	43.4	3.2	343.2
2000	145.8	46.7	3.1	452.3
2005	151.8	49.9	3.0	603.5
2010	156.9	53.8	2.9	814.9
2015	159.8	59.6	2.7	1,147.8
2020	161.1	66.7	2.4	1,645.6
2025	161.9	73.8	2.2	2,320.1
2030	163.0	79.2	2.1	3,174.3
2035	164.6	82.5	2.0	4,213.6
2040	166.1	83.7	2.0	[b]
2045	167.1	84.9	2.0	[b]
2050	167.8	86.4	1.9	[b]
2055	168.2	88.8	1.9	[b]
2060	168.6	91.1	1.9	[b]
2065	169.2	92.9	1.8	[b]
2070	169.7	94.4	1.8	[b]

[a]Benefit amounts are in current dollars—not adjusted for inflation.

[b]Benefits payable for years after 2035 were not available.

Source: 1993 Annual Report of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Fund (Washington, D.C.: GPO, Apr. 7, 1993).

New Legislation Makes More Benefit Dollars Taxable

As a way to reduce the annual budget deficit, the Congress passed the Omnibus Budget Reconciliation Act of 1993. The act increases the maximum proportion of a taxpayer's social security benefits subject to income tax from 50 to 85 percent beginning in 1994 for taxpayers over new income thresholds. In the future, taxpayers will have to compare their countable income to two sets of thresholds when determining how much of their benefits are taxable. The additional revenues from this new legislation are to be credited to the Hospital Insurance trust fund.

For example, if a married taxpayer filing a joint return has countable income of between $32,000 and $44,000, no more than 50 percent of their benefits will be taxable. However, if their countable income is over $44,000, up to 85 percent of their benefits will be taxable. Similar changes exist for a single taxpayer. The changes in taxing of benefits take effect in 1994 and will affect the taxes of an estimated 3 million higher-income recipients. Table 3.4 depicts the new tax thresholds and tax rule.

Table 3.4: New Social Security Benefit Tax Provisions Effective in Tax Year 1994

Tax filing status	Countable income	Maximum proportion of benefits taxable (percent)
Single	$25,000-34,000	50
	over $34,000	85
Married joint	$32,000-44,000	50
	over $44,000	85

Practicality of Requiring Information Returns

Before implementing any additional internal control, the costs of requiring information returns for tax-exempt income need to be considered relative to the benefits. We spoke to both IRS and representatives of various sectors of the financial services industry about anticipated costs associated with reporting and processing additional income information.

IRS officials said there would be incremental costs for receiving and processing information returns. For example, the Office of the Assistant Commissioner for Examination estimated that the incremental cost of receiving and entering data from these returns was about 20 cents per return. These costs could be mitigated, however, if the tax-exempt income was reported on an existing information return rather than requiring a new, separate information return.

We held a roundtable discussion with members of the financial services industry (banking, investment brokers, mutual funds, paying agents, and enrolled agents). Industry representatives told us that reporting on unregistered bearer bonds and original issue discount (OID) bonds would be difficult if not impossible. Basically, the financial services industry has no information on investors who hold bearer bonds and little information on OIDs. However, they noted that these types of securities constitute an unknown, but assumed to be small and declining, percentage of the tax-exempt market—probably less than 10 percent.

The industry representatives said that reporting tax-exempt income would improve IRS' tax compliance capabilities. However, they believed reporting for all investors would impose a processing burden on the industry. They reasoned that many unnecessary information returns would be required for recipients whose tax liability would not be changed by this type of income.

We believe that this burden is tempered by the fact that earnings information is already generated and provided to most investors in tax-exempt securities. However, a copy of it is not given to IRS. We recognize that tax-exempt income does not affect the taxable income of all persons investing in these securities. However, there are presently over 40 million social security recipients, many of whom invest in tax-exempt securities, and a growing proportion will be subject to the tax as inflation and real wage growth drive up benefits and their incomes relative to the taxable income thresholds that remain constant.

Conclusion

Controls are vital to effective financial administration, especially when they directly involve the receipt and expenditure of revenues. IRS' controls over tax revenues owed on social security benefits are weak because it lacks information returns on tax-exempt interest. Without these returns, IRS cannot verify that more than 40 million beneficiaries accurately calculate the taxes owed on their benefits. Consequently, equitable administration of the tax on social security benefits cannot be ensured and an unknown amount of program revenue is being lost. This shortcoming in IRS' controls for administering this tax may be especially serious in the future because of the anticipated dramatic growth in both (1) the amount of benefits subject to the tax and (2) the government's reliance on it to meet future program obligations.

Recommendation

Given the uncertainty of the tax revenue losses from underreporting of tax-exempt income and the financial industry's potential processing burden, we recommend that IRS conduct a detailed study of tax returns to better identify the benefits of having payers report tax-exempt income. In addition, IRS should obtain data on the costs of reporting and processing such information. The study could involve IRS' 1994 Taxpayer Compliance Measurement Program (TCMP) or a pilot study that solicits the cooperation of several payers so that the benefits and costs of reporting tax-exempt income can be estimated. If a favorable cost-benefit ratio is identified, IRS should take appropriate steps to make it possible to routinely acquire this information.

Agency Comments

In its written comments on a draft of the report, IRS generally agreed that further study is needed of how tax-exempt interest affects the tax on social security benefits. Specifically, IRS stated it is interested in measuring the compliance and noncompliance levels with respect to taxable social security benefits. IRS said the major changes effective for 1994 in the threshold and amount of benefits subject to income tax make this the appropriate year to study.

Before it commits to conducting a pilot test, IRS said it will use its 1994 TCMP to measure the benefits of reporting. In the 1994 TCMP, IRS plans to examine 92,000 Form 1040 returns. A segment of these returns will be used to measure compliance with the tax on social security benefits. Under TCMP all income, deduction, and exemption items on the returns will be examined, allowing an analysis of the levels of compliance related to underreporting of tax-exempt interest. Results of this survey will be published and appropriate program changes and legislative proposals will be recommended.

While this approach appears reasonable, we caution that assessing underreporting of tax-exempt interest by using TCMP will be difficult. TCMP uses information returns to identify noncompliance in the reporting of income and allowable deductions, but examiners are to probe beyond such reports in determining tax liabilities. Because information returns do not exist for tax-exempt income, IRS examiners will have to perform specific audit work to detect such income. If TCMP requires this type of work, then IRS may be able to reliably assess compliance with the reporting of tax-exempt income and how noncompliance affects the tax on social security benefits.

TCMP will not, however, provide any information on the costs of reporting and processing information on tax-exempt income. Thus, some additional study of this matter will be needed. Given IRS' commitment to study this issue in the 1994 TCMP, we have revised our recommendation to reflect its plans.

In a letter dated June 20, 1994, the Commissioner of Social Security said that she concurred with our recommendation for a pilot test. She noted that the recommendation has the potential to increase trust fund revenues if the test shows that collection of tax-exempt income data is cost-beneficial.

Comments From the Internal Revenue Service

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER

July 18, 1994

Mr. Joseph Delfico
Director, Income Security Issues
Human Resources Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. Delfico:

Thank you for the opportunity to review your recent draft report entitled, "Social Security: Trust Funds Can Be More Accurately Funded."

The report contains a recommendation directed to IRS involving a pilot test to estimate the benefits and costs of reporting tax-exempt interest. The complete recommendation and our comments are as follows:

RECOMMENDATION TO IRS

Given the uncertainty of the tax revenue losses from underreporting of tax-exempt income and processing burden referenced by the financial services industry, we recommend that IRS solicit the cooperation of several payers of this income so that it can conduct a pilot test to better estimate the benefits and costs of reporting tax-exempt interest. If a favorable cost-benefit ratio is identified, IRS should take appropriate steps to routinely acquire this information.

COMMENT:

Internal Revenue Code section 6049(b)(2)(B) (Information Returns Regarding Payments of Interest) excepts from the definition of interest, "interest on any obligation if such interest is exempt from tax under section 103(a)..." Section 103(a) exempts interest on any state or local bond from tax (with exceptions not applicable here). Consequently, the IRS does not have any authority to require information reporting on tax-exempt interest on state or local government bonds.

However, IRS is interested in measuring the compliance and non-compliance levels with respect to taxable social security benefits. Due to a major change to the threshold for taxable benefits and amount of benefits subject to income tax made by the Omnibus Budget Reconciliation Act of 1993 and effective for 1994,

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Mr. Joseph Delfico

any research or study should now be based on 1994 tax returns. We believe that the scope and nature of our efforts should be based on preliminary analysis of available information. The benefits of reporting would be the recoupment of lost tax revenues, and we believe that an estimate of this should be developed before committing to conduct a pilot test. Our currently scheduled Taxpayer Compliance Measurement Program (TCMP) survey of 1994 tax returns filed in 1995 will examine 153,000 returns, of which 92,000 will be Form 1040 based, 33,000 non-business and 59,000 business. All income, deduction, and exemption items on the returns will be examined, and this will allow us to analyze the levels of compliance related to underreporting of tax exempt interest. Results of this survey will be published, and appropriate program changes and legislative proposals will be recommended.

We hope you find these comments useful.

Sincerely,

Margaret Milner Richardson

Margaret Milner Richardson

Comments From the Department of the Treasury, Office of Tax Analysis

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

July 5, 1994

Mr. Joseph Delfico
Director, Income Security and Issues
Human Resources Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. Delfico:

Thank you for the opportunity to comment on the recently completed General Accounting Office draft titled, "Social Security: Trust Funds Can Be More Accurately Funded." The report contains a recommendation to the Secretary of the Treasury that transfers be made to the social security trust funds of additional tax liability that are identified by the Internal Revenue Service's (IRS) underreporter program. Specifically, the recommendation is (p. 21):

Now on p. 17.

RECOMMENDATION TO THE SECRETARY OF THE TREASURY

> We recommend that the Secretary of the Treasury revise its methodology for transferring revenues to the trust funds derived from taxing social security benefits. Treasury's transfer methodology should recognize the amount of additional tax liabilities related to social security benefits identified through IRS's underreporter program.

COMMENT

Treasury's Office of Tax Analysis (OTA) is aware that the IRS's underreporting program can identify underreported income which results in additional assessed taxes. In addition, the program can identify the amounts assessed on underreported income where social security benefits is the primary issue. However, as the report itself points out, several factors make it impossible to determine the precise amount of additional tax assessment due to the underreporting of social security benefits. First, the report concludes,

> IRS does not precisely track additional tax assessments by the many different elements of income and deductible expenses that comprise a tax return. When it detects multiple problems involving the underreporting of income on a tax return, IRS attributes any additional tax assessment to the primary element where a reporting problem was detected. Thus, a portion of the [additional amount assessed where social security benefits are identified as the primary issue] may represent assessments not related to social security benefits. Likewise, there are likely other assessments for underreported taxable benefits that have been made, but cannot be identified because these cases are

associated with a different primary issue.

OTA agrees with the report that this limitation to the underreporter program data exists. Currently, the underreporter program has no method for identifying assessed amounts that relate solely to the taxation of social security benefits, nor for identifying other additional assessments for which social security benefits are not the primary issue but for which underreporting of social security benefits may be an issue. Thus, the assumption made by GAO in the report that such factors "cancel each other" cannot be verified.

Second, the report finds,

> IRS cannot determine how much of the [additional amount assessed where social security benefits are identified as the primary issue] are for unpaid taxes versus interest and penalties. This distinction is important because the trust funds are only entitled to revenues from the assessments for unpaid taxes.

OTA also recognizes that the underreporter program cannot separate tax assessments from interest and penalties for tax years 1984-1988. As noted, the social security trust funds by law are not entitled to receive interest and penalties on tax assessments. The law also does not entitle the social security trust funds to interest accrued on any under-transfer of taxation of benefit liabilities to compensate for lost investment opportunities; likewise, the general fund of the Treasury is not entitled to interest on any over-transfer to the social security trust funds for taxation of benefit liabilities to compensate for lost investment opportunities. Despite the clarity of the law on this point, the GAO report suggests overcoming the underreporter program data limitation by assuming that the interest charged for underpaid taxes is roughly equivalent to the lost investment opportunity that the trust funds have suffered from not having access to the additional tax assessments from 1984-1990.

In conclusion, OTA suggests that no additional transfers to the social security trust funds be made for underreported tax liability on social security benefits until such liability can be more precisely measured.

Sincerely,

Lowell Dworin

Lowell Dworin, Director
Office of Tax Analysis

cc: Lora Shepp, Linda Herbert

Comments From the Social Security Administration

THE COMMISSIONER OF SOCIAL SECURITY
BALTIMORE, MARYLAND 21235

JUN 20 1994

Mr. Joseph F. Delfico
Director
Income Security Issues
U.S. General Accounting Office
1 Massachusetts Avenue
Room 400, National Guard Building
Washington, D.C. 20548

Dear Mr. Delfico:

Enclosed is our response to the General Accounting Office draft report, "Social Security: Trust Funds Can Be More Accurately Funded." If we can be of further assistance, please let us know.

Sincerely,

Shirley S. Chater

Shirley S. Chater
Commissioner
of Social Security

Enclosure

SOCIAL SECURITY ADMINISTRATION COMMENTS ON THE GENERAL ACCOUNTING OFFICE DRAFT REPORT, "SOCIAL SECURITY: TRUST FUNDS CAN BE MORE ACCURATELY FUNDED"

We appreciate the opportunity to comment on the General Accounting Office (GAO) draft report. With the number of individuals entitled to benefits growing each year, it is imperative that amounts credited to the trust funds accurately reflect all Social Security taxes collected. As such, we concur with the recommendations presented in the report. Our response to the specific recommendations are as follows:

GAO Recommendation

We recommend that the Secretary of the Treasury revise its methodology for transferring revenues to the trust funds derived from taxing Social Security benefits. Treasury's transfer methodology should recognize the amount of additional tax liabilities related to Social Security benefits identified through the Internal Revenue Services (IRS) underreporter program.

Social Security Administration (SSA) Response

We concur. Implementation of the recommendation would result in the transfer to the Social Security trust funds revenues that are improperly being credited to the general funds. The portion of revenues collected by IRS through its information return enforcement program, that result from the underreporting of Social Security benefits, are not being credited to the Social Security trust funds. This flaw in IRS and Treasury procedures should be corrected as soon as possible.

In addition, Treasury should work with IRS to determine the best estimate of undercrediting of the trust funds for prior tax years (TY) and transfer these amounts (including lost interest on trust fund investments) to the trust funds. Treasury and IRS should use the most recent TY's experience with respect to additional revenues resulting from the enforcement process and apply these results to taxation of benefit data for prior TYs.

GAO Recommendation

Given the uncertainty of the tax revenue losses from underreporting of tax-exempt income and processing burden referenced by the financial services industry, we recommend that IRS solicit the cooperation of several payers of this income so that it can conduct a pilot test to better estimate the benefits and costs of reporting tax-exempt interest. If a favorable cost-benefit ratio is identified, IRS should take appropriate steps to routinely acquire this information.

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SSA Response

We concur. This recommendation has the potential to increase revenues if the test shows that collection of tax-exempt income data is cost-beneficial, and if IRS implements such data collection and uses it properly for enforcement and credits the trust funds with the additional revenues collected.

Other Matters

Now on p. 2.

The discussion of the thresholds for taxation of Social Security benefits on pages 1 and 2 in the draft states that the threshold for married persons filing separately is $0. Though that is correct for married persons who file separately and do not live apart at all times during the year, the thresholds for married persons filing separately who do live apart at all times during the taxable year are the same as those for a single taxpayer, i.e., $25,000 and $34,000, respectively. We believe this should be clarified in the report.

Now on pp. 19 and 25.

On pages 23-24 and 33-34 of the report, GAO provides an explanation of the calculations needed to determine if, and how much of, an individual's or couples' Social Security benefits are subject to taxation. GAO refers to the calculated amount as "modified adjusted gross income." The term according to the report is calculated by adding two types of income to adjusted gross income: Tax exempt interest and half of a taxpayer's Social Security benefit. Technically, the term "modified adjusted gross income," as defined in section 86(b)(2) of the Internal Revenue Code, does not include any of the taxpayer's Social Security benefits, rather the taxpayer must add one-half of his or her Social Security benefits to his or her modified adjusted gross income and compare that sum to the thresholds. We believe GAO should either use a different term to describe the sum of those two quantities or, if it wishes to continue using the technical term "modified adjusted gross income," revise the draft to reflect the meaning given to that term by statute.

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