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Ask Bob: Why Do I Pay Taxes On My Social Security and Pension Benefits?

A reader wonders if the government is "double dipping" by taxing her Social Security benefits.

ROBERT POWELL, CFP®| May 4, 2021

Question

Haven't we already paid taxes on the money that went into Social Security? Why are we paying taxes again? And if we have a pension, haven't we paid taxes on the money that went into the pension?

Answer

Only part of the money an individual contributes to Social Security has had taxes paid on it, says Martha Shedden, RSSA, CRPC, president and co-founder of The National Association of

Registered Social Security Analysts (NARSSA). "The history and rational for why and how much of Social Security income is taxable, are quite complex."

Shedden provides this background: Employees are subject to certain deductions from their paychecks, which are generally referred to as "payroll taxes." For most employees, their entire pay is subject to federal (and possibly state) income taxes, including that part that is subject to Social Security "payroll taxes."

The Social Security "payroll tax," is the employee's contribution into FICA, or the *Federal Insurance Contributions Act*, the official name for Social Security. The FICA deduction is not a tax that is paid to the IRS, but a contribution into the Social Security and Medicare Trust Fund. Since the employee's income that the FICA contribution is based on was subject to federal income tax, the contribution is considered to be "after-tax income."

Employees contribute 6.2% of their earnings to Social Security and 1.45% to Medicare, for a total deduction of 7.65%. Employers also pay the same 7.65% amount into FICA, meaning each employee has 15.3% contributed into the trust fund with each payroll.

"Contributions to FICA are not kept in personal FICA accounts though," notes Shedden. "In fact, the benefits paid to retirees today are being paid by current workers' contributions."

When someone begins to collect Social Security retirement benefits, she continues, the amount they receive is based on their past earnings and the age at which they start collecting and is not dependent on how much they actually contributed into FICA.

The value of the "before-tax income," i.e., the employer's contribution, received by retired workers collecting Social Security is potentially taxable. And likewise, only that portion of the worker's "after-tax income" on which he paid payroll taxes, is not taxable. The question is then, how much of the average retiree's Social Security benefit not taxable.

Shedden explains that after a great deal of rigorous effort and calculation, the general consensus is that the average beneficiary's benefit that was directly paid for by the beneficiary, is about 15%. "Therefore, about 85% of the average Social Security benefit represents the amount in excess of that contributed to the program by the average worker."

Read this article to learn more about how taxation of Social Security income is calculated.

"If you are covered by a traditional employer-owned pension plan," says Shedden, "and the plan is totally employer-funded, you will not have paid any taxes because you make no direct contributions to these plans."

You can read about the history of taxation of Social Security benefits and how this also relates to taxation of private pensions.

Assistant editor Kim McSheridan assisted with this report.

Got questions? Get answers!

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