

**DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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Dear *****:

The Director, Tax Exempt Bonds, has asked me to respond to your letter with regard to the treatment of tax exempt bond interest for purposes of determining the taxability of social security benefits under section 86 of the Internal Revenue Code.

Section 86 of the Code, as enacted by Congress, generally, requires that taxpayers who receive substantial income from sources other than Social Security include a portion of their social security benefits in their gross income.

Section 86(a) provides, in general, that gross income for the taxable year of any taxpayer described in subsection (b) includes social security benefits in an amount equal to the lesser of :

- (1) One-half of the social security benefits received during the taxable year, or
- (2) One-half of the excess described in subsection (b)(1).

Section 86(b)(1) describes as a taxpayer one whose "modified adjusted gross income" plus one-half of the Social security benefits received exceeds the "base amount," which for taxpayers filing jointly is \$32,000.

Section 86(b)(2)(B) defines "modified adjusted gross income" as "adjusted gross income" increased by the amount of interest received or accrued by the taxpayer during the taxable year which is exempt from tax.

As you are aware , in calculating "modified adjusted gross income" (which is then used to determine what portion, if any, of a taxpayer's Social Security benefits are included in gross income), tax exempt income, including the interest on tax exempt bonds, is included.

The Court of Appeals for the Federal Circuit considered the question of whether section 86 results in the taxation of tax exempt bond interest in Boli v. United States (1987 CA FC) 831 F2d 276, In that case the Court concluded that the inclusion of tax-exempt interest in "modified adjusted gross income" under section 86 results in a tax on Social Security benefits and not on the interest.

The Court notes that on its face, section 86 imposes a tax on Social Security benefits, not on tax-exempt interest. It provides that in certain circumstances "gross income "includes" a portion of Social

Security benefits. The effect of treating Social Security benefits as part of gross income is to subject those benefits to the federal income tax. Relying in part on Shapiro v. Baker, 646 F. Supp 1127,1132 (D.N.J. 1986) the Court further notes that the formula created in section 86 is to include all amounts of income from whatever source so as to determine how much of the social security income should be taxed. The tax is a tax on Social Security benefits even though, in determining the amount of those benefits to be taxed, all of the taxpayer's other income, including tax-exempt income, is considered.

While, as the appellants in Boli pointed out, the effect of including tax-exempt interest in determining a taxpayer's "modified adjusted gross income" is, in some situations , to increase the liability for tax, the increased tax results from the inclusion of Social Security benefits in gross income that is taxed and not from a tax on the interest itself.

The legislative history of section 86 confirmed the Appeals Court's conclusion that section 86 does not constitute a tax on municipal bond interest. The House Conference Report, notes that Section 86 was designed to tax a portion of Social Security income when the recipient also had substantial income from other sources. See H.R. Conf. Rep. No 47, 98th Cong. 1st Sess. 122-23, reprinted in 1983 U.S. Cong. & Adm News, 143, 404, 412-23. Senate Report No. 23, 98th Cong. 1st Sess., 25-28, reprinted in U.S. Code Cong & Adm News 143, 166-69, notes that the tax is intended to strengthen financially the Social Security System by taxing a portion of social Security benefits, thus providing equal treatment of all forms of retirement benefits, and by using those additional revenues to augment the Social Security fund. The Senate Report stated that :

This provision does not affect the exclusion for interest on tax exempt obligations. Rather, it merely includes the interest in the base for the purpose of determining the amount of an individual's social security benefits that will be taxed.

I hope this clarifies the purpose and operation of section 86 and the computation of the "modified adjusted gross income." Please let us know if we can be of any further assistance.

Sincerely yours,

Clifford Gannett
Manager, Tax Exempt Bonds
Outreach, Planning and Review