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

OFFICE OF
CHIEF COUNSEL

June 26, 2008

UIL: 86.01-00

Number: **INFO 2008-0027**
Release Date: 9/26/2008

CONEX-124430-08

The Honorable Richard Lugar
United States Senate
Washington, DC 20510

Attention:

Dear Senator Lugar:

I am responding to your letter dated May 19, 2008, on behalf of your constituent, asked about the inclusion of tax-exempt interest in determining the amount of his taxable social security benefits.

Gross income may include a portion of social security benefits [section 86(a)(1) of the Internal Revenue Code]. Generally, if the only source of a recipient's income is social security benefits, then we do not tax those benefits. However, we may tax a portion of social security benefits if the recipient receives other income in addition to social security benefits. When the total income exceeds certain amounts, a part of the social security benefits are taxable. This method of taxing social security benefits assures that lower-income individuals, who rely on their benefits to afford basic necessities, are not taxed on their benefits and that taxpayers who have substantial taxable income from other sources are taxed on a portion of their benefits.

Taxpayers must calculate their modified adjusted gross income to determine if social security benefits are taxable [section 86(b)(2) of the Internal Revenue Code]. Taxpayers must include tax-exempt interest in modified adjusted gross income when calculating the amount of taxable social security benefits.

As Congress explained in the legislative history when it enacted section 86, the law does not affect the exclusion from income for interest on tax-exempt obligations. It merely requires the inclusion of tax-exempt interest in adjusted gross income when determining the amount of taxable social security benefits. [S. Rep. No. 98-23, 98th Cong., 1st Sess. 25, 27 (1983), 1983-2 C.B. 326, 328].

Although the tax-exempt interest is not itself taxable, it can cause the taxation of additional social security benefits because the interest is added to adjusted gross income to form a larger modified adjusted gross income. If a taxpayer fails to include the tax-exempt interest in the calculation of modified adjusted gross income, he or she may underreport the amount of the taxable social security benefits. Thus, the taxpayer may be liable for additional tax, interest, and penalties.

I hope this information is helpful. As requested, I am replying in duplicate and returning your enclosure. If you have any questions, please contact me at ( ) or at ( ) .

Sincerely,

Nancy J. Marks
Division Counsel/Associate Chief Counsel
(Tax Exempt & Government Entities)

Enclosures (2)