

# PERSONAL INVESTMENT MANAGEMENT, INC

## White Paper #2

Social Security Review

By

Christopher J. Reedy: April 2011

### **Contents**

In this addition we cover the basics of Social Security. The specific topic sections are: Brief History of Social Security, Funding Social Security (the Social Security Shortfall), Eligibility for Benefits, Cost of Living Increases, Higher Benefits to Delay Filing for Social Security, Reduction in Social Security Due To Earned Income, Tax Treatment of Social Security Benefits and Social Security Disability.

### **Brief History of Social Security**

President Franklin D. Roosevelt signed the Social Security Act on August 14, 1935. OASDI – “Old Age, Survivors, and Disability Insurance” and Medicare are programs of the Social Security Act. Given the lively dialogue in recent years about the cost of social security and the classification of its benefits and programs as “entitlements” it is important to remember that the program was originally designed to be, and still is a social insurance program paid for by workers and their employers.

The Federal Insurance Contributions Act (FICA) imposes taxes on employers and employees to fund OASI (Old Age and Survivors Insurance), DI (Disability Insurance) and HI (Medicare Hospital Insurance).

The maximum annual cost to workers and their employers in 1940 was \$60.00; in 2011 the maximum annual cost is \$13,243 (the healthcare portion however, is uncapped and applies at 2.9% to unlimited compensation).

Since 1935, several amendments have been enacted expanding the scope of Social Security:

- 1935 Social Security Act
- 1940 Survivors’ Benefits
- 1950 Survivors’ Benefits for Husbands and Widowers
- 1955 Cost of Living Adjustments
- 1956 Age 62 Retirement Option for Women
- 1957 Disability Benefits

- 1960 Disability Amended
- 1961 Age 62 Retirement Option for Men
- 1965 Medicare
- 1975 Automatic COLA Adjustments
- 1984 Social Security Reform
- 2006 Medicare Prescription Drug Program

As can be seen, what began as an income benefit for workers now includes benefits for the spouse and survivors, for disability and includes cost of living adjustments.

### **Funding Social Security (the Social Security Shortfall)**

This topic is fairly complex, so here we present a summary of the structure and financial management of Social Security.

Social Security reserves do not reside in an account as cash, nor is the money stockpiled somewhere in the basement of the Treasury Department. Rather, Social Security buys special US Treasury Bonds. As with any government bonds these special Treasury Bonds pay interest and are backed by the full faith and credit of the US Government to tax its citizens. The interest generated from the purchase of the bonds is accrued as general revenue to the Social Security account and is a significant contributing factor of the total Social Security program budget. The Federal Government takes the proceeds from the sale of the bonds and accounts for this as general revenue earmarked for Social Security expenditures. In other words, the “Social Security Trust Fund” does not contain cash; it contains interest-bearing US Treasury Bonds, the interest income from which is a key component of the financial solvency of the program.

Due partly to the advancement of the baby boomer generation into retirement, it is anticipated that Social Security reserves will be depleted by 2037. If/when that happens, the non-existent reserves will no longer earn interest, and the only income to the Social Security system will be regularly collected taxes from current workers and their employers. These taxes are estimated to be sufficient to cover about 78% of the anticipated benefits to be paid after 2037. The shortfall of 22% and is the subject of the current debate. Talking heads commonly refer to the Social Security system as insolvent, broke, on the brink of collapse etc. This is factually incorrect and may potentially elicit emotional or enthusiastic rhetoric.

What should be understood is that the fundamental conditions upon which Social Security was originally conceived and enacted have changed. In 1900 very few people

actually retired; the average life span of a male born in that year was just 46 years – for a female, 49 years. In 1935, average aggregate life expectancy was 61 years, with Social Security benefits to begin at age 65. Today, the life expectancy for a male is 75.3 years and for a female, 80.3 years. And clearly, many outlive the averages. Yet “Full Retirement Age” (FRA) is still from age 65-67 (with reduced benefits available as early as age 62). According to one source, moving the FRA up a year or two would solve the current dilemma.

### **Eligibility for Benefits**

Qualification for Social Security benefits involves more than can be conveyed here. The following is a general summary that is a reasonable starting point for further analysis.

To achieve “Fully Insured” status, one must have earned 40 quarters of qualified coverage. A quarter of coverage is earned for every \$1,120 a worker earns, with a maximum 4 quarters of coverage able to be earned in any calendar year. Earning \$4,480.00 during any year (even if within a week or a month) = the maximum 4 quarters of coverage. Assuming the earnings requirement is met, it takes 10 years of employment to achieve fully insured status. Note: the formula is different for those born before 1929.

Those with a lesser work history but who seek to receive benefits still may be able to do so if they can meet the requirements to be considered “Currently Insured”. Currently Insured status requires the achievement of coverage during 6 of the most recent 13 quarters (leading to the event causing the application for benefits).

At age 62, reduced benefits are available. At Full Retirement Age, full benefits are available. Full retirement age now depends on the year of birth. Certain benefits, such as Social Security Disability and Survivor benefits may be available earlier than retirement age; qualification requirements for these are too numerous to be identified here.

### **Cost of Living Increases**

On January 1<sup>st</sup> of each year, Social Security benefits are increased based on the 3<sup>rd</sup> quarter to 3<sup>rd</sup> quarter change in the U.S. Consumer Price Index. Increases were enacted each year from 2000 through 2009. No increases were enacted for 2010 or 2011.

## **Higher Benefits to Delay Filing for Social Security**

Choosing to delay filing for Social Security at your Full Retirement Age will result in increased benefits when you eventually do file. The amount of the increase may be substantial and is based on how long you delay and your year of birth. The following represents the % benefit increase per year of delay:

<u>Year of Birth</u>	<u>Benefit Increase %</u>
1935-36	6.0%
1937-38	6.5%
1939-40	7.0%
1941-42	7.5%
1943 or Later	8.0%

John Smith was born in 1944 and will turn 66 (his Full Retirement Age) in 2010. His monthly Social Security benefit at age 66 (FRA) is \$1,500 per month. If John delays filing for Social Security until age 70, his benefit will be increase by 32% (4 Year Delay X 8% per year). Therefore, when John begins Social Security at age 70, his monthly benefit will be  $\$1,500 \times 1.32 = \$1,980$  per month.

## **Reduction in Social Security due to Earned Income**

Unearned income (investment returns, pension and retirement plan distributions, etc) has no impact on the amount of Social Security benefits paid. The value of assets owned has no impact on the amount of Social Security benefits paid. Earned Income, if you are UNDER your Full Retirement Age will have an impact on the amount of Social Security retirement benefits paid. If you are at or over Full Retirement Age, there is no impact. The formulas for determining the deductions are as follows:

For 2011, per individual, the earned income limit is \$14,160 for those who initiated Social Security benefit payments between the age of 62 and the year prior to attaining Full Retirement Age. Beyond the earned income limit, Social Security Benefits are reduced by \$1 for every \$2 of earned income. Using round numbers, a \$20,000 annual Social Security retirement benefit would be reduced to zero in a year during which the recipient earned income of \$54,160.

If you had earnings in the same year you achieved FRA (in the year you turned 66, for example) and initiated benefits, but if those earnings were during the months prior to turning 66 and starting benefits, the earnings test formula is a reduction of \$1 of benefits

for every \$3 of earned income. The lesson here is to be thoughtful of the amount of earned income you may achieve in the months prior to your birthday during the year you turn Full Retirement Age.

### **Tax Treatment of Social Security Benefits**

The measure of income for this purpose is called “Provisional Income” and is generally defined as:

Adjusted Gross Income + Tax Exempt Interest Income + 50% of Social Security Income  
(though other items may be included)

If Provisional Income exceeds the thresholds below, then Social Security benefits are subject to federal income tax as follows:

<u>Tax Rate</u>	<u>50%</u>	<u>85%</u>
Single, Head of Household, Widow(er)	\$25,000	\$34,000
Married, filing and living separately	\$25,000	\$34,000
Married, filing jointly	\$32,000	\$44,000

However, as the ultimate taxable amount of Social Security is based on the amount that falls within the ranges, it is helpful to see an example:

John and Mary are receiving \$26,000 in Social Security Retirement benefits. They earned \$5,000 in tax exempt interest income, and they're combined adjusted gross income is \$31,000 (employment earnings, pension and retirement plan income).

The first step is to add AGI + Tax Exempt Income + 50% of Social Security =  $\$31,000 + \$5,000 + \$13,000 = \$49,000$

The second step is to determine the amount of Social Security benefit to be taxed at the 50% level. Since Provisional Income exceeds the maximum allowable for a married couple filing jointly (\$44,000), we simply take 50% of the amount between \$32,000 and \$44,000 ( $\$12,000$ ) = \$6,000

The third step is to determine the amount of Social Security benefit to be taxed at the 85% level. That threshold starts at \$44,000, so we subtract

total Provisional Income (\$49,000) from the threshold amount (\$44,000) = \$5,000 and multiply by the applicable rate of 85% = \$4,250.

The Final step is to sum the results of steps two and three (\$6,000 + \$4,250) = \$10,250.

Therefore, \$10,250 of John and Mary's total Social Security Retirement benefits of \$26,000 is includible as federally taxable income.

### **Social Security Disability**

The eligibility requirements for Social Security Disability Benefits are quite stringent. And the physical condition necessitating an application for Social Security Disability must be serious. The following is a summary of the work history requirements, the conditional requirements, the waiting period, the benefit amount and duration and the family benefits.

**Definition of Insured (work history):** The applicant must be fully insured at the time the disability began and if age 31 or older, have been employed in a Social Security covered job for at least 5 of the past 10 years (20 of 40 available quarters of qualification). If the disability started before age 31, then the applicant must have been engaged in Social Security covered employment for the greater of 6 quarters or at least one-half of the quarters between age 21 and the onset of the disability. The applicant must be below his/her Full Retirement Age, as disability benefits after FRA become retirement benefits.

**Qualifications for Receipt of Benefits:** The applicant must have a physical or mental disability that has prevented the applicant from the performance of any substantial work for the prior 12 months, or is expected to prevent the applicant from performing any substantial work for the coming 12 months or result in death.

**Waiting Period:** There is a 5 month waiting period before benefits begin.

**Benefit Amount:** Each year, the Social Security Administration sends out a statement detailing the benefit amount we've earned and specifies the amount of benefit if retirement or disability started today as well as the benefit amounts if initiated in later years. The technical term for this amount is PIA – Primary Insurance Amount. A disabled person who qualifies for Social Security Disability benefits will receive 100% of his/her specific PIA.

**Duration:** Benefits will be paid until one month after the end of the qualifying disability, until the benefit recipient dies (benefits actually cease one month prior to death because

benefits are paid following the month during which they are earned) or until the recipient attains full retirement age, at which point, disability benefits become retirement benefits.

Family Disability Benefits: The spouse and children of a disabled worker may be eligible for family benefits. Qualification and benefit amounts depend on the spouse's age, the ages of dependent children, and the family is subject to a "family maximum" benefit which may result in a reduction from the aggregate of what would be paid to each qualifying family member individually.

Though the benefit amounts are different, the same general guidelines apply to dependent family members of a deceased spouse/parent. There are too many conditions to relate herein. Suffice it to say that the spouse and dependent children of a disabled or deceased person with a work history sufficient to qualify for benefits may be eligible to receive either 50%, 75% or 100% of the disabled or deceased person's Social Security benefits, limited by age, marital status and the family maximum allowance.

### **Source and Recommendations**

The primary source of material for this White Paper is an academic textbook from the CFP Certification Professional Education Program: Retirement Planning & Employee Benefits – Planning for Retirement & Social Security.

Clearly, Social Security is a large and complex program. It is difficult to do much more than generally summarize key topic areas. Yet, we hope this White Paper has been interesting and informative.

We intend to produce another White Paper exclusively about Medicare / Medicaid. You may expect this to be available in the coming weeks.

### **Disclaimer**

As an SEC Registered Investment Adviser (and as commons sense dictates), PIM is specifically prohibited from the unauthorized practice of law and from giving specific tax advice.

Therefore, should the issues discussed herein pertain to you, or if you have additional questions about Social Security retirement, disability or survivor benefits or the taxation of these, please see the Social Security website for further details: [www.ssa.gov](http://www.ssa.gov) and/or consult with a qualified tax or legal professional.