

# Wealth Management

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## What You Need to Know About Social Security, Part I

Social Security is in the news and on many retiree's and pre-retiree's minds these days. It's an important source of many people's retirement income, a "third rail" of American politics, and along with Medicare the 800-pound gorilla affecting our nation's long-term debt. So, over the next three installments, I'll examine this important topic in detail. In this first installment, I'll talk about the fundamentals of Social Security. You may want to save this article for future reference next month, especially for the terminology.

### **Social Security offers five key benefits:**

- 1. An income you cannot outlive with an inflation adjustment.** If your benefit is \$2,000 today, in 30 years you stand to receive \$4,580, assuming a 2.8% COLA. And that's a whopping \$1.16 million in cumulative payments, and far more than you paid into the system. Why is this so important? Two reasons: 1) it is that much less you must take from your portfolio each month, especially in down markets, and 2) The sheer amount coming due to the baby boomer generation has major financial implications for our nation.
- 2. A spousal benefit.** Your spouse is entitled to the greater of ½ of your benefit or his/her own benefit, starting as early as age 62. Thus, if your spouse is entitled to receive \$800 per month based on his/her earnings, and you are entitled to receive \$2,000, you spouse will receive \$1,000 per month, and as a couple you will receive \$3,000.
- 3. Divorce benefits.** If your marriage lasted 10 years or more, you are entitled to the same spousal benefit as if you were married. Benefits paid to you are not affected by benefits paid to your ex, current spouse, and other ex-spouses. The benefits stop if you remarry.
- 4. A survivor benefit.** When one spouse dies, the survivor receives the higher of two benefits, as early as age 60. Thus, if before you died you were receiving \$2,000 per month and your spouse was receiving \$1,500 per month, your spouse would receive \$2,000 per month. If your spouse died first, you would continue to receive \$2,000. Granted the survivor has less income than the couple enjoyed, but it is still an important benefit for widows and widowers. It also provides a monthly survivor benefit for minor children. Over my career, I have seen this fund several college educations when it was properly invested when the child was young.
- 5. Disability benefits.** If you become fully disabled you are eligible for disability benefits, based on your prior earnings.

## So just how are benefits calculated?

You do not have to figure this out yourself, as five calculators are available at [socialsecurity.gov](http://socialsecurity.gov). Financial advisors with advanced software can also provide calculations that integrate with the rest of your retirement planning. The exact amount of your Social Security benefit is not computed until you turn 62. At that time, all your annual earnings are indexed for inflation. And meanwhile, you can check your annual statement to get a longer-range projection. But for those who must know, here is what goes on in the “black box.”

1. Select the highest 35 years of earnings (missing years are counted as zeroes). The word “earnings” only applies to the maximum amount subject to the FICA tax. In 1975, for example that was \$14,100. In 2010 it is \$106,800.
2. Each of the 35 years is indexed for inflation.
3. The 35 indexed years are totaled, and divided by 35 to arrive at your *average indexed monthly earnings*, or *AIME*.
4. A three-part formula applies “bend points” to your AIME to determine your *primary insurance amount (PIA)*.

This is the amount you'll receive at *full retirement age (FRA)* which is 66 for baby boomers born between 1943 and 1954). The benefit is increased each year by cost-of-living adjustments (COLAs). It can also be increased by any higher earnings years, will replace lower ones.

Let's take Dr. Smith, born in 1948, now age 62, who earned the maximum amount all 35 years. When his earnings are indexed and averaged, his AIME comes out to be \$7,260.

- The first \$711 of the AIME is multiplied by 90%.
- The amount between \$711 and \$4,288 (\$3,577) is multiplied by 32%.
- The amount over \$4,288 (\$2,972) is multiplied by 15%.
- ***The PIA is \$2,230. This is the amount Dr. Smith will receive at age 66. Adjusted for inflation, it will be higher at age 66. It could also be more if he worked four more years with higher earnings to replace four lower-earning years.***

## Timing

When you actually take your benefit can have a big impact on what it will be. The starting point is the full retirement age, or FRA. For those born between 1943 and 1954, the FRA is 66. Between 1954 and 1960, the FRA increases gradually to age 67.

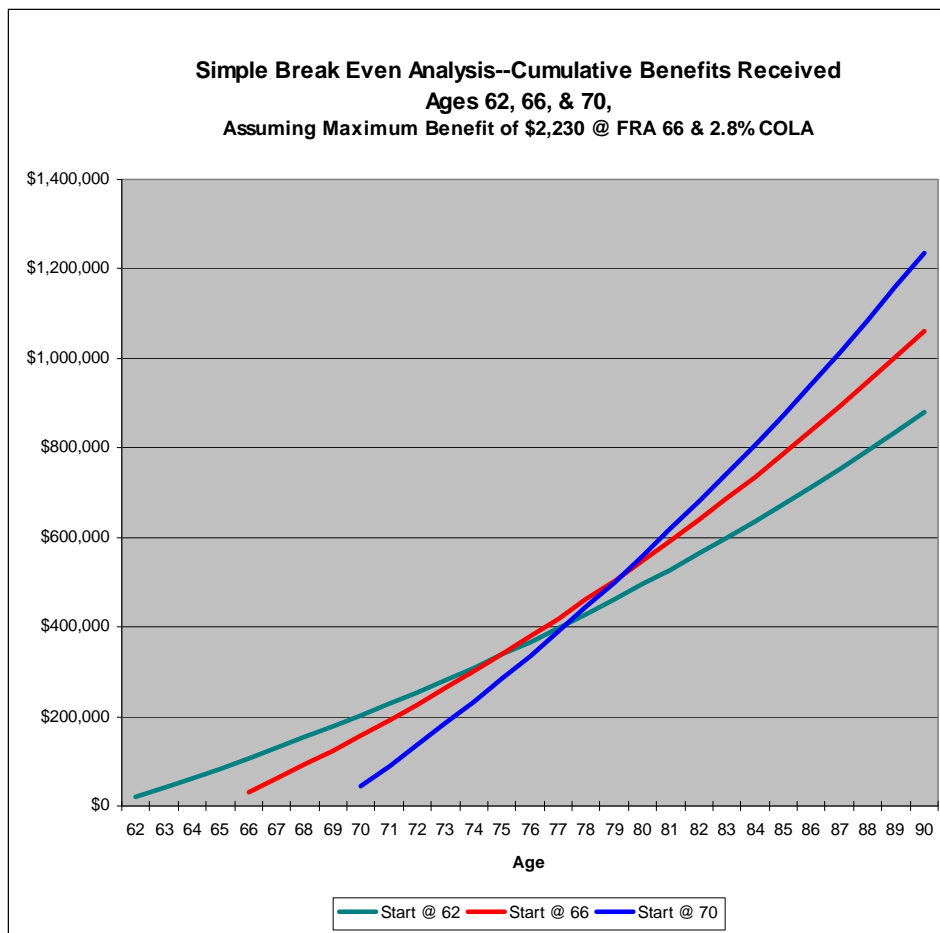
Apply at age	Benefit will be % of PIA	Example if PIA is \$2,230
62	75.0%	\$1,672
63	80.0%	\$1,784
64	86.7%	\$1,933
65	93.3%	\$2,080

We rarely recommend taking benefits prior to the FRA unless the income is needed, or if we are going to use one of the spousal strategies I'll discuss in the next installment. But one of the main considerations is whether or not you continue to work. ***If you are less than the current FRA of***

**66, for every \$2 you earn above \$14,160, \$1 will be deducted from your monthly benefit. In the year you turn 66, \$1 will be deducted for every \$3 you make over \$37,680.** However, this is not lost. Once you reach your FRA, your benefit will be adjusted to compensate for the deductions. Once you are at the FRA, you can earn all you can without any benefit adjustments. And if you delay even further, you stand to earn a higher benefit.

Apply at age	Benefit will be % of PIA	Example if PIA is \$2,230
66	100%	\$2,230
67	108%	\$2,408
68	116%	\$2,587
69	124%	\$2,765
70	132%	\$2,943

As you can see by the graph, there are tradeoffs. Your life expectancy is the wild card. On a simplistic basis of just counting the total dollars received, if you started benefits at age 66 instead of 62, your breakeven age is 75. If you waited until age 70, your break even age is 78. And the breakeven between ages 66 and 70 is age 80.



## Taxation on Social Security Benefits

Just plan on them mostly being taxed. Basically, if your income exceeds \$25,000 as a single or \$32,000 for married filing jointly, up to 50% of your benefits will be taxed. And if your income is \$34,000 as a single or \$44,000 married, up to 85% of your benefits will be taxed. Income includes pensions, interest, dividends, earned income, and even tax-free bond income.

### Check it out!

There are many more nuances and details I didn't cover in the interest of space. ***Again, check out the award-winning Social Security website. It is very informative and easy to use.*** You will find five different calculators on that site. Interestingly, they all gave me slightly different results given the same set of facts from my latest annual statement (which provided the lowest benefit estimates).

***Next:*** Planning strategies to integrate Social Security into your retirement planning.

***Part #3:*** The future of Social Security, possible fixes, and how they may apply to most ChartNotes readers.

*(Ron Kelemen is an independent CERTIFIED FINANCIAL PLANNER™ with 29 years of experience, and is listed by Medical Economics magazine as one of The 150 Best Financial Advisors For Doctors. He was also admitted to the MD Preferred Network of Financial Advisors. He offers fee-only investment management and wealth management advice through The H Group, Inc., one of the largest independent registered investment advisory firms in the Northwest. 500 Liberty St. SE, Suite #310 • Salem, OR 97301 • (800) 285-6240 • website: [www.PlanningVisionProcess.com](http://www.PlanningVisionProcess.com))*

