



## Wealth Management

By Ron Kelemen, CFP®

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

Social Security is in the news and on many retirees' and pre-retirees' 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, which 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**

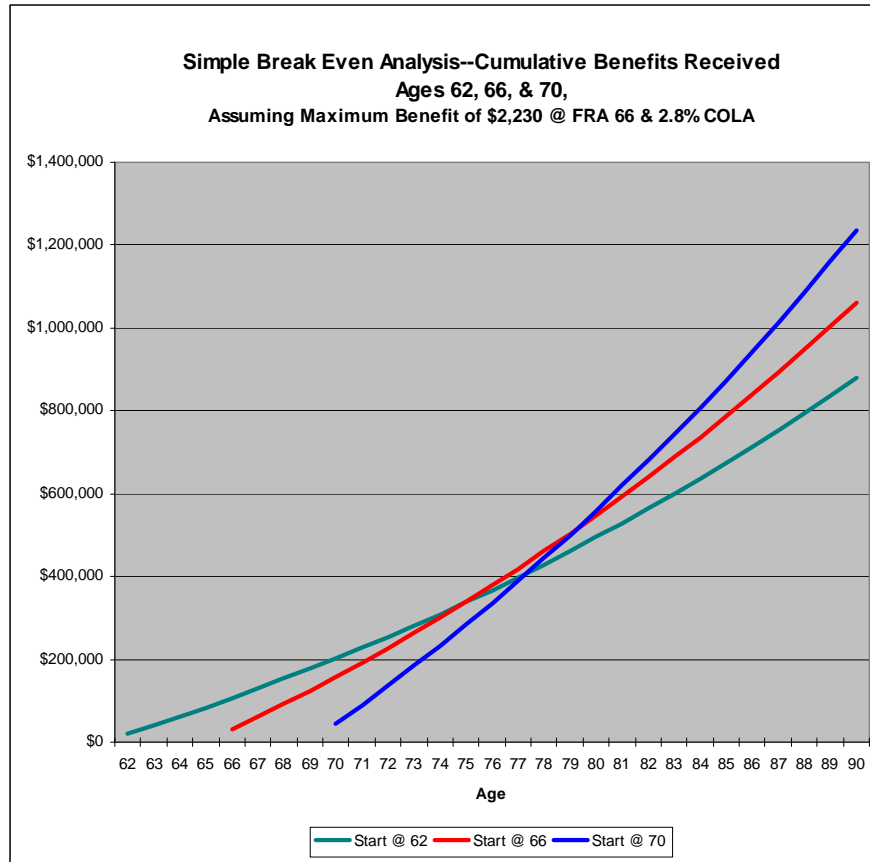
Choosing when you actually take your benefit can have a big impact on what it will be. The starting point is the full retirement age, or FRA. For those born between 1943 and 1954, the FRA is 66. Between 1954 and 1960, the FRA increases gradually to age 67.

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.

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## **What You Need to Know About Social Security—Part II** *Four Benefit Strategies for Married Couples*

**By Ron Kelemen, CFP®**

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*(Note: Last month I discussed the basics of Social Security. You may want to refer back to the newsletter tab of the July issue of ChartNotes at [www.mpmedsociety.org](http://www.mpmedsociety.org) for definitions and important concepts that are the building blocks of this installment.)*

When the parents or grandparents of today's baby boomers applied for Social Security it was no big deal. They just did it and started receiving checks. The program was very simple back then. Benefits started only at age 65 and didn't even have a cost of living increase (COLA). Gradually, benefits improved and things got very complicated (and expensive for the system!). Now, regardless of your income or other assets, Social Security planning should be an important part of your retirement planning. Many of the planning opportunities revolve around married couples. This installment will focus on the most common question we receive about Social Security—when should I start taking benefits?

Your age at the time you start taking benefits can literally make the difference of many thousands of dollars over your lifetime. Before we get into the number crunching, it's important to realize that your decision of when to apply depends on many factors unique to your situation. These include your:

- health status
- life expectancy
- retirement lifestyle
- need for income
- whether or not you plan to work
- whether you have other personal income resources.

As I pointed out last month, 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. But what if you try the “take and invest” strategy?

### **1. The “Take and Invest” Strategy**

As you can see by the table, the breakeven ages are higher if you took benefits at 62 and dutifully invested your Social Security check each month until age 70.

**Breakeven Ages if Age 62-70 Benefits Invested  
Compared to Postponing Benefits to Age 70**  
(Assumes maximum PIA of \$2,230 at age 66 with 2.8% COLA)

<b>Investment</b>	<b>Not invested</b>	<b>4% Return</b>	<b>6% Return</b>	<b>8% Return</b>
Breakeven Age	78	81	84	90

This may not be a fair comparison, because I’m comparing a higher-risk investment strategy with a government-guaranteed benefit. And it doesn’t consider the taxation of Social Security benefits or of investment returns. This “take and invest” strategy can only work if you can afford to invest all of your Social Security benefits and are willing to take risks in an attempt to earn 8% or more. But for this to work, you must not need the income and really must have a high tolerance for risk—and discipline that I have rarely seen in 29 years of practice.

*All of this discussion is based on a single life. The picture changes dramatically when we factor in the planning opportunities available to married couples.* As I pointed out last month, your spouse is entitled to the greater of one-half 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, your spouse will receive \$1,000 per month, and as a couple, you will receive \$3,000.

*There is also a death benefit, and this is a very important consideration, especially since the life expectancy on two lives is greater than just one.* 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. This leads to a key strategy—File and Suspend.

## **2. The File and Suspend Strategy**

For one to start receiving spousal benefits, the other spouse must first file for benefits. *The basic premise of this strategy is that by filing, a higher-earning spouse makes his spouse eligible for spousal benefits. By suspending the receipt of his own benefit, he builds credits toward a higher benefit at age 70.* For example, let’s say the wife is the lower-earning spouse. Her husband files, and then suspends taking benefits. This enables her to start taking benefits on her own record at, say, age 62 and then switch to taking half of the husband’s benefit at a later age. Alternatively, she can claim to get one-half of her husband’s PIA (benefit amount), actuarially adjusted by her age.

This “file and suspend” strategy works best if one-half of the husband’s PIA is greater than the wife’s, and if the husband continues working to accumulate more credits. The longer he waits, the better, ideally to age 70. This tends to maximize the couple’s lifetime benefits, especially when the COLA is factored in. More importantly, it maximizes the survivor benefit, regardless of who survives. Thus, the breakeven age for a surviving spouse getting a stepped-up spousal death benefit is the same as that of a single individual, even if the deceased spouse lived only one day past age 70. The actuarial reductions for starting this strategy before age 66 are slightly different, as you can see by the tables. And note that it never pays for a spouse to apply for a spousal benefit after age 66.

## Actuarial Adjustments for Spouse and Using Other Spouse's Benefit (PIA)

Age wife files for benefits	% of wife's PIA	Benefit if wife's PIA is \$800	% of husband's PIA	Benefit if husband's PIA is \$2,000
62	75.0	\$600	35.0	\$700
63	80.0	\$640	37.5	\$750
64	86.7	\$693	41.7	\$834
65	93.3	\$746	45.8	\$916
66	100.0	\$800	50.0	\$1,000
67	108	\$864	50.0	\$1,000
68	116	\$928	50.0	\$1,000
69	132	\$992	50.0	\$1,000
70	132	\$1,056	50.0	\$1,000

### 3. Claim Twice

This strategy works best for high-income couples with relatively equal earnings. A spouse in a dual-earner couple can claim Social Security twice: first as a spouse and later using his or her own work record. The husband, for example, may choose to sign up for only a spouse's benefits at age 66 and then claim again based on his own working record when he exits the workforce at age 70. But note again, that it never pays for a spouse to apply for a spousal benefit after age 66.

### 4. The "Do-Over" Strategy

This is basically the "Take and Invest" strategy. This option was originally permitted for people who made an honest mistake by claiming benefits at age 62, then going back to work. The rules permit one to withdraw the application, repay the amount received (without interest!) and reapply at a later date. I'm only mentioning it because we have had questions about it following a Scott Burns column last year and irrational fears that Social Security will be completely insolvent in the next eight years. Investment returns and tax considerations aside, the real risk here is that you die before you plan to complete the deal. ***Don't do it!*** You are dooming your surviving spouse to a lifetime of thousands of dollars of lower benefits on a gamble that you can make a few bucks now. Once scenario we ran for a client showed the widow receiving only half as much at age 80 as she would have if they had just stayed on their original claim and suspend tract. And since this is too good to be true, Congress will most certainly close this loophole.

### Key Points

1. ***The actuarial reduction for early retirement is permanent!*** If you start benefits at 62 and die, your spouse's benefits will be based on that lower amount for the rest of his or her life.
2. ***Don't underestimate the power of the annual COLA!*** Even if you don't die early, the annual COLA can potentially more than double your benefits over your lifetime. That is why it is generally better to postpone receiving benefits to as late as possible—the annual COLA percentage is applied to a higher PIA.
3. If you continue working past age 66 or 70 your benefits are recalculated each year. If these are your peak earning years, they replace your lower earning years from the 35-year average. This is good for many doctors who didn't make much as residents early in their careers.

4. If a spouse or widow earns more than the earnings test amounts--\$14,160 before FRA or \$37,680 in the year he/she turns FRA in 2010—benefits will be withheld the same as for regular Social Security benefits.
5. ***If you lose benefits because you worked before age 66, they are not lost.*** They are factored in again at age 66. But it is still better to postpone benefits if you will be working.
6. The higher-earning spouse should delay benefits to age 70, if possible. This is especially true if the higher-earning spouse is male and three or more years older than his spouse.
7. ***Run the numbers!*** Social Security is too important for guess work. The examples in this article are hypothetical and probably don't accurately apply to your situation. There are many variations on the strategies I discussed, so your decision needs to be made in the context of the many factors mentioned earlier. A comprehensive advisor with sophisticated software can assist you with this.

**Next month:** *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))*





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### What You Need to Know About Social Security—Part III Its Future and 10 Possible Fixes

“Social Security Payouts To Exceed Revenue”—March 24 *New York Times*

“Faith in Social Security Tanks.”—July 20 *USA Today*

“The financial condition of the Social Security and Medicare programs remains challenging. Projected long run program costs are not sustainable under current program parameters.”

—Executive Summary of 2009 OASDI Trustees Report on the condition of Social Security

“Ron, I want to take my Social Security benefit now, while there is still something left.”—February 2010 comment from a 62-year old client of mine.

With headlines and comments like these, it’s obvious that people are skeptical about the solvency of the Social Security system. A July 8-11 USA Today/Gallup Poll revealed that 60% of non-retired adults polled said that they didn’t think the Social Security system will be able to pay a benefit when they retire. And 75% of those 18-34-years old don’t expect any benefits at retirement. Of those retired, 56% thought that their benefits will eventually be cut.

But to really understand what’s going on and how it affects you, we need to go beyond headlines poll results, and the political rhetoric. Let’s look at some facts, and then try to put them into perspective.

According to the Congressional Budget office, Social Security payouts in 2010 will exceed payroll taxes. This wasn’t supposed to happen until 2016. With such a high unemployment rate, it is no wonder. We simply have fewer workers paying payroll taxes. ***In reality, the Trust Fund will actually have a \$91 billion surplus when US Treasury bond interest and all sources are included.***

#### 2010 Projected Income, Outgo, and Ending Balance

*(In Billions, with rounding)*

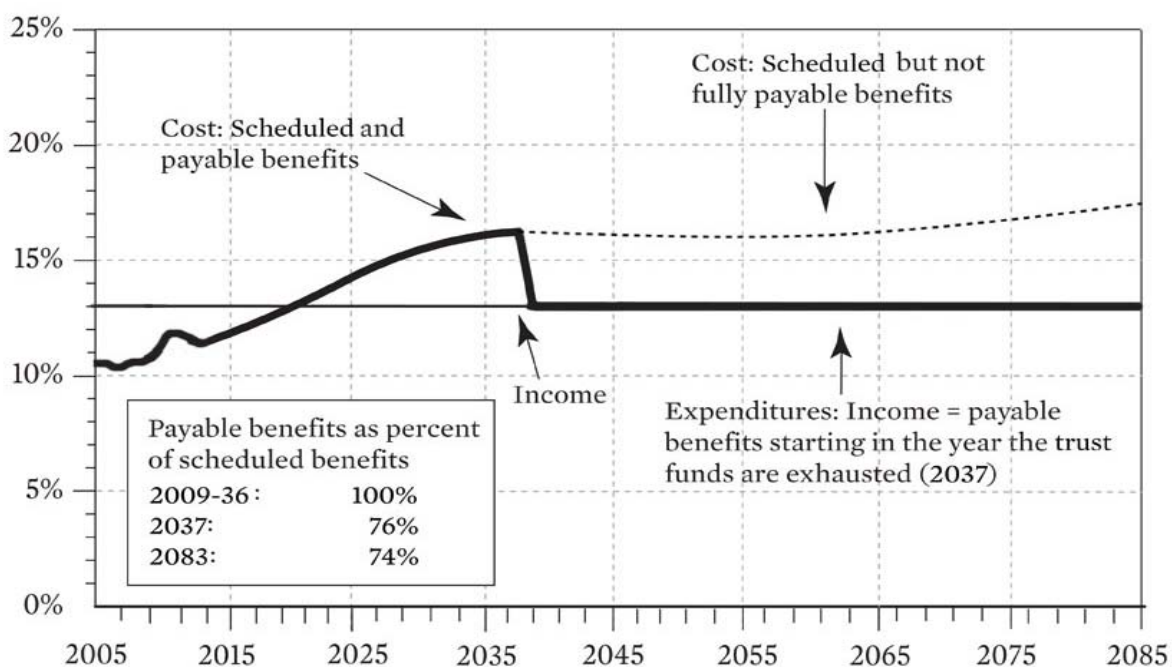
Total Income	From Payroll Taxes	From Interest & Other	Payouts	Surplus	Ending Balance

		Sources			
\$799	\$642	\$157	\$697	\$91	\$2,594

(Source: Congressional Budget Office)

When we talk about Social Security solvency, we need to distinguish between the disability fund (DI) and the Old Age & Survivors retirement fund (OAS). Together they are called the OASDI. The DI fund is in particularly bad shape, projected to have insufficient assets to pay claims by 2016 unless changes are made. Disability claims since the recession have skyrocketed. And Medicare is projected to run a deficit starting in 2011. Fortunately, the retirement portion of the Social Security Trust Fund (OAS) is much better. According to the 2009 OASDI Trustees Report, The OAS fund can pay full benefits until 2036 without any changes to the program. *So, today's retirees and baby boomers knocking on the retirement door are probably okay for the next 20 years.*

**OASDI Income and Cost Rates Under Intermediate Assumptions  
(As a percentage of taxable payroll)**



Source: 2009 OASDI Trustees Annual Report

### The Social Security Trust Fund

Before we get much further, let's take a look at the much maligned Social Security Trust Fund. Until sometime this year, payroll taxes have exceeded benefit payments. As you can see by the table, the Social Security Trust fund has a surplus of \$2.6 Trillion. Where is it? What did it do with the extra cash? Like many individuals, government agencies (like the FDIC), and governments around the world, the Trustees invested it in a special form of the most secure investment in the world—US Treasury bonds. *If the United States had no debt, where could this surplus have been safely invested?* Unlike you and me, it was prohibited from investing in

stocks, corporate bonds or real estate. To fund benefit payments, the OASDI trust fund will gradually need to cash in its US Treasury bonds over the next 75 years. The current \$2.6 Trillion represents 19% of the current 13.3 Trillion US debt.

### **So what would it take to solve the problem?**

To answer that, the OASDI Trustees publish three simple statistics every year to help us.

1. The amount of **cash infusion** that would be needed to build sufficient trust fund reserves. According to the 2010 report, the trust fund would require a cash infusion right now of \$5.4 trillion to pay promised benefits over the next 75 years. That's the present value of the difference between costs and income.
2. "The Actuarial Deficit." This is the amount the annual **payroll taxes** (currently 12.4%) need to be increased. For 2010, that amount is 1.92%, bringing the payroll tax to 14.3%. By comparison, it was 1.7% in 2008, 2.0% in 2009, and it has been higher and lower than 2% in other years.
3. The amount of **benefit cuts** to match income. The 2010 report shows that benefits would need to be cut by 12.0%.

In the words of the Trustees, "Ensuring that the system remains solvent on a sustainable basis beyond the next 75 years would require larger changes because increasing longevity will result in people receiving benefits for ever longer periods of retirement."

### **Possible Fixes**

*It will probably take a combination of measures. They basically boil down to raising taxes or lowering benefits.* Some of the statistics cited below come from the American Academy of Actuaries (AAA) at [www.actuary.org](http://www.actuary.org).

1. **Increase the payroll tax.** This falls particularly hard on younger workers. They generally make much less than baby boomers and are facing a later full retirement age (FRA) and reduced benefits. There will be less of them supporting a larger aging population. From an economic standpoint, it kills new job creation, because the payroll tax falls upon employers equally.
2. **Increase the limit on taxable earnings.** Social security was originally designed to have 90% of all earnings in covered employment subject to the payroll tax. The limit is currently \$106,800. But earnings growth has been disproportionate between high and low income workers, so now the ratio is 85%. The AAA estimates that removing the limit entirely would eliminate the whole deficit and leave a small surplus. This is one fix that seems to be getting some political traction.
3. **Raise the retirement age.** For those born after 1954 the FRA is age 67. The proposals being floated call for raising the age to 68-70, particularly for those in their 30's or younger. For desk jockeys, that might be okay. But what about those jobs that involve hard manual labor? The non-partisan Congressional Budget Office says this would have no significant and immediate effect on the trust fund. The AAA estimates it could reduce the actuarial

deficit by one-third to two-thirds, depending upon how fast it is implemented. What it really does is shift the cost of the retiring boomer generation onto the younger generation. As a father of two 20-somethings, I find this morally wrong, especially if they must also pay increased payroll taxes and take a benefit cut when they finally do get benefits.

4. **Reduce benefits across the board.** As mentioned by the 2009 Trustees report, a 13.3% cut would restore solvency to the program. Who is going to have the political courage to take on that one?
5. **Increase the taxation of benefits.** Taxes on benefits currently represent about 2% of the income received by Social Security. The Academy of Actuaries estimates that making all benefits taxable would only reduce the deficit by about one-sixth.
6. **Change the benefit formula and get back to basics.** If you read the first two installments in this series carefully, it was hard to miss how generous Social Security benefits really are, particularly as they pertain to spousal benefits. Three formulas are used in calculating benefits. Without going into detail, these could be adjusted to gradually result in reduced benefits for new Social Security beneficiaries. The savings would depend upon how much the formulas are changed, but in combination with other changes, would help solve the problem.
7. **Reduce COLAs.** The AAA estimates that a COLA reduction of 0.5% per year would eliminate about 40% of Social Security's long-term deficit. Unlike other changes, a COLA change could be enacted quickly. Of course this hurts retirees, but younger workers paying into the system— if they even have a job—haven't had COLAs and may have endured pay cuts. (See my generational equity comments in #3 above.)
8. **Invest in other assets, such as stocks.** Phasing this in over 15 years and assuming a 6.5% real rate of return over the long term, this could reduce the deficit by 40%. But there are a lot of "ifs" about this and concerns about how it would affect the financial markets—both now and when the boomers have moved through the system.
9. **Means testing.** This may erode public support for Social Security, particularly among the higher-income workers who pay more into the system. And it could create potential fraud and abuse as the wealthy seek to hide or transfer assets and income to protect their benefits. Many of the same results could be achieved through changes in the benefit formula or through changes in the income taxation of benefits.
10. **Individual accounts.** We wrote about this in 2005, and given what's happened in the stock market since then, it's a good thing that wasn't implemented then. The AAA notes in a 2007 white paper that this by itself will not address Social Security's deficit.

*No matter what combination of fixes, there will be winners and losers, and that is why the problem is so politically difficult.* As the Congressional Budget office pointed out, every year of delay equals higher taxes and lower benefits for the future. It's also another way to pass our problem down the road for our children and grandchildren.

*Social Security will be there for today's retirees and boomers; perhaps in a slightly different form than as we know it today. But in the end, whether it is through payroll taxes, income*

*taxes, or savings, all that will be there for tomorrow's retirees will be what they (or their children) send on ahead.*

I hope you found this series helpful. I've enjoyed writing it and I appreciate the many favorable comments I have received on the first two installments. If you'd like a combined PDF of all three articles in this series, they are posted in the newsletter section of my website at [www.PlanningVisionProcess.com](http://www.PlanningVisionProcess.com).

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