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Social Security Retirement

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Farmers and many other self-employed business owners who report income on the cash-basis have a tremendous amount of planning flexibility with regard to managing their Social Security costs and benefits. Ironically, given the significance of self-employment tax to the overall tax liability, few of these business owners have traditionally taken advantage of pro-active strategies for optimizing their self-employment/Social Security costs and returns. Is this an opportunity for your consulting practice?

Different strategies should be utilized during different phases of one's career. Early on, just meeting and maintaining eligibility requirements for Social Security retirement, disability, and survivor benefits will be of extreme importance. However, in the later phase of one's career, the business owner may want to focus on maximizing the returns on retirement dollars, while maintaining eligibility for Social Security disability benefits.

Most people qualifying for Social Security retirement benefits have contributed to the system for many more years than the required minimum. This is because for individuals born after 1929, only the highest 35 years of indexed earnings are utilized in the calculation of retirement benefits.

For individuals born after 1928, forty quarters of earnings coverage are needed to be fully insured for retirement benefits. Once an individual earns the 40 quarters of coverage, they are fully insured for life.

An alternative test for coverage is utilized for younger workers. A younger worker will be considered fully insured if they have at least six quarters of coverage and have a quarter of coverage for each year after age 21 and before the year of death or disability.

A maximum of four quarters can be earned per year and are determined by the amount of earnings reported for a particular year. Earnings required for quarters of coverage since 1990 are as follows:

1990	$520	1998	$700
1991	$540	1999	$740
1992	$570	2000	$780
1993	$590	2001	$830
1994	$620	2002	$870
1995	$630	2003	$890
1996	$640	2004	$900
1997	$670	2005	$920

The normal or full retirement age (NRA or FRA) is being gradually increased from age 65 to age 67. The following table presents the age of full retirement given the individual's year of birth. Individuals retiring at their FRA are eligible to receive 100% of their primary insurance amount (PIA).

Age To Receive Full Social Security Benefits	
Year of Birth	**Full Retirement Age**
1937 or earlier	65
1938	65 and 2 months
1939	65 and 4 months
1940	65 and 6 months
1941	65 and 8 months
1942	65 and 10 months
1943–1954	66
1955	66 and 2 months
1956	66 and 4 months
1957	66 and 6 months
1958	66 and 8 months
1959	66 and 10 months
1960 and later	67

Factors having the greatest influence on the return from Social Security retirement system contributions are:

- Magnitude of Past Earnings
- Marital Status and Spouses Earnings
- Life Expectancy
- Number of Years of Earnings and the Magnitude of the Lowest Years
- Type of Tax Paid (FICA vs. SE)

Individuals electing to retire earlier than their FRA will receive reduced benefit payments for the duration of their life, to compensate for the amount of benefits received prior to their FRA. The majority of Americans elect to receive benefits prior to their FRA. The reduction for earlier retirement to individual's benefits will vary from 20 to 30% depending on the individual's year of birth and the number of months in advance of their FRA they elect to start receiving benefits. The following table provides information relative to early retirement elections by the worker and their spouse.

Year of Birth	Full Retirement Age	Age 62 Reduction Months	Monthly % Reduction	Total % Reduction	Monthly % Reduction (spouse)	Total % Reduction (spouse)
1937 or earlier	65	36	.555	20.00	.694	62.50
1938	65 and 2 months	38	.548	20.83	.679	62.92
1939	65 and 4 months	40	.541	21.67	.667	63.34
1940	65 and 6 months	42	.535	22.50	.655	63.75
1941	65 and 8 months	44	.530	23.33	.644	64.17
1942	65 and 10 months	46	.525	24.17	.634	64.58
1943-1954	66	48	.520	25.00	.625	65.00
1955	66 and 2 months	50	.516	25.84	.617	65.42
1956	66 and 4 months	52	.512	26.66	.609	65.84
1957	66 and 6 months	54	.509	27.50	.602	66.25
1958	66 and 8 months	56	.505	28.33	.595	66.67
1959	66 and 10 months	58	.502	29.17	.589	67.08
1960 and later	67	60	.500	30.00	.583	67.50

1. If you were born on January 1st, you should refer to the previous year.
2. If you were born on the 1st of the month, we figure the benefit as if your birthday was in the previous month.
3. The maximum benefit is 50% of the benefit the worker would receive at full retirement age. The monthly % reduction for the spouse does not include the automatic 50% reduction. Percentages are approximate due to rounding.

Some individuals elect to delay their retirement and the commencement of retirement benefits. These individuals receive an increase in their monthly benefits to compensate for the benefit payments forgone between their FRA and when they begin receiving payments. This credit is also used to compensate retirees that lose their early retirement benefits due to the excess earning penalty.

Increases For Delayed Retirement	
Year of Birth	**Yearly Rate of Increase**
1917—1924	3.0%
1925—1926	3.5%
1927—1928	4.0%
1929—1930	4.5%
1931—1932	5.0%
1933—1934	5.5%
1935—1936	6.0%
1937—1938	6.5%
1939—1940	7.0%
1941—1942	7.5%
1943 or later	8.0%

The decision to elect early, normal, or delayed retirement is never made with certainty. Many factors, most for which the individual has no control, will impact the financial outcome of the decision. These factors include: length of life, amount of earned income during retirement, level of other retirement income, rate of inflation, and changes in tax rates.

While the Social Security program is complex, the formula for calculating retirement benefits is relatively straight-forward. An individual's Social Security retirement benefit is the sum of three separate percentages of portions of the average indexed monthly earnings. For individuals who first become eligible for Social Security retirement benefits in 2004, their benefit will be the sum of:

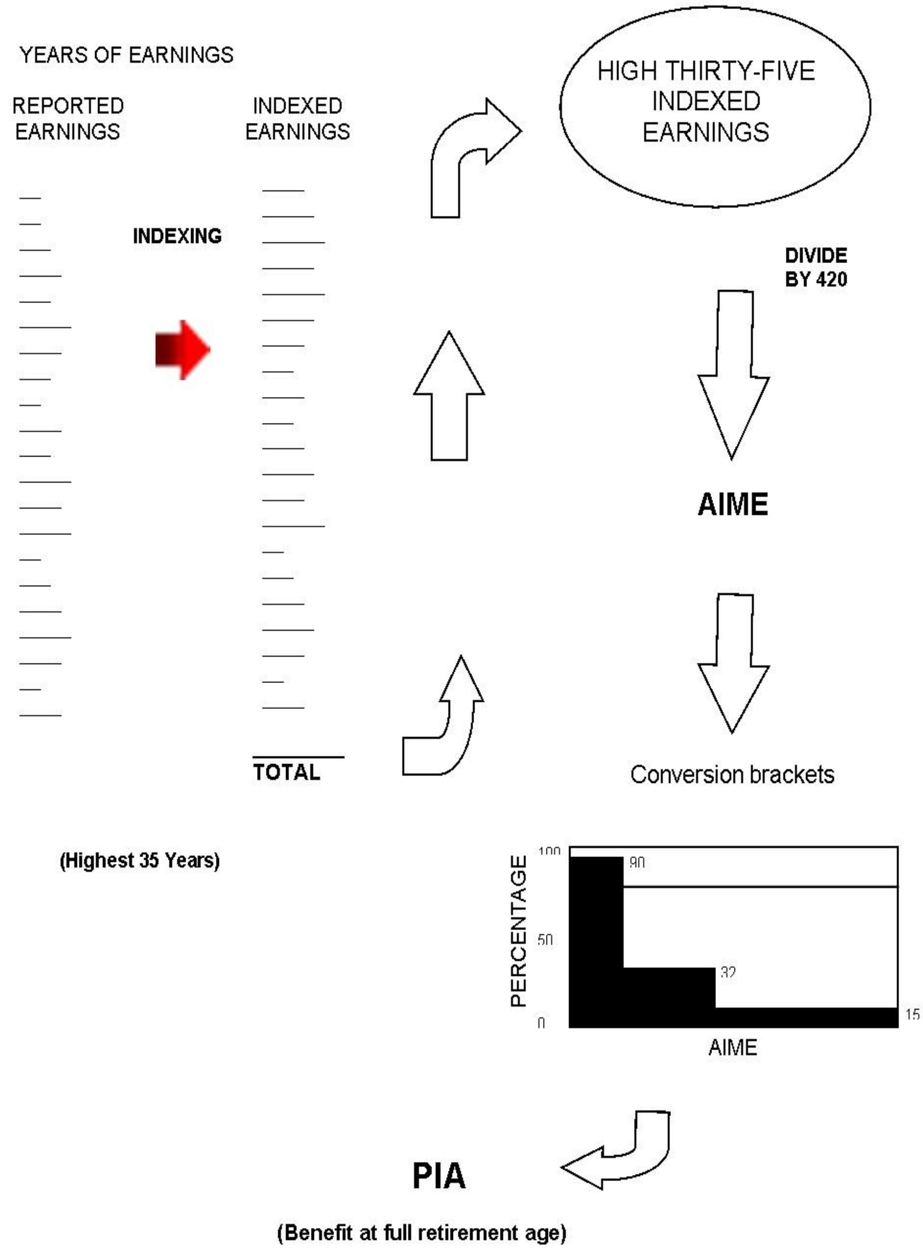
a. 90% of the first $612 of their average indexed monthly earnings (AIME), plus
b. 32% of their AIME over $612 and through $3,689, plus
c. 15% of their AIME over $3,689

The product of this calculation is also known as the Primary Insurance Amount (PIA). The following diagram illustrates the computational flow for calculating the PIA.

The return from additional contribution to Social Security would generally be best for a married person, whose spouse will receive spousal benefits, who has an above average life expectancy, and is still in the 90% bend conversion bracket.

On the other hand, the profile that would likely produce a poor return would be a single man or one whose spouse will receive benefits based on their own earnings history, has a poor life expectancy, has a earnings history which put him in the 15% bend conversion bracket.

Computing a Social Security Benefit



Points to Ponder and Strategies for Consideration:

Bend points are important to understand because they determine how much of a worker's average indexed monthly earnings will be converted to benefits at the 90, 32, and 15 percent levels. The bend points used for a specific person are those released for the year they turn 62.

More than 70 percent of Americans aged 85 and over are women.

The majority of women rely on Social Security's spousal or widow benefits. Social Security actuaries predict that even among those retiring in 2015, only about 20 percent of widows will have earned benefits greater than those of their spousal benefits.

To qualify for widow(er)'s benefits, one must be married for one year in the case of death from natural causes; nine months in the case of accidental death.

Stay-at-home spouses or spouses with a low earnings compared to that of their spouses need to be aware of the 10 ten-year marriage requirement for being eligible for Social Security retirement benefits based on their spouses' earnings. A stay-at-home spouse who divorces their spouse at 9 years, 11 months, and 27 days may someday feel like they lost twice (first at marriage and second at Social Security benefits).

For a husband and wife who are both engaged in the same self-employment venture – farming for example – how is their income reported for Social Security? More thought should be given to how this income should be reported than it typically receives. If all of the income is reported under one spouse's Social Security number, the other spouse from the Social Security angle would have the same earnings pattern as a stay-at-home spouse.

From a financial perspective, if the couple remains married for life, at no point of the earnings spectrum would a couple be better off splitting the earnings history and each reporting half.

For the spouse with a low earnings history who is receiving the Social Security's spousal benefit, that means they are not receiving any additional benefit from the amount of Social Security taxes they contributed during their working career.

Given the pronounced effect of indexing on earnings early in one's career, Social Security contributed from part-time or lower-paying employment activities late in one's working career may not result in any increase to their Social Security retirement benefits

The costs of maintaining a home, transportation costs, food costs, etc. are not reduced by half with the loss of a spouse; the surviving spouse is likely to face a reduction in retirement benefits that exceeds their reduction in living costs.

Children with net earnings of $400 or more from **4-H or FFA projects** that are entered into primarily for educational purposes and not-for-profit are exempt from self-employment taxes since the activity is not considered a trade or business. However, if the 4-H or FFA project was entered into for the purpose of developing a trade or business, then the income would be subject to self-employment tax.

For workers with average to above average earnings, inflating earnings in the last few years prior to retirement is seldom a sound economic decision. Many professional planners believe a majority of today's workers will see 85-96 percent of their benefits accrued by age 50.

On the other hand, since earnings at any age are considered in the calculation of Social Security retirement benefits, earnings during retirement can favorable impact the retirement benefit for a worker with a lower than average earnings history.

Individuals applying for Social Security retirement benefits who also qualify for pension benefits from work not covered by Social Security may receive reduced benefits due to two special provisions: 1) windfall elimination provision and 2) government pension offset.

> Since Social Security retirement benefits are calculated to provide the greatest percentage of earnings return to low-income workers, the **windfall elimination provision** was enacted to prevent "government employees" from qualifying for the 90% "bend return factor". For individuals who reach 62 years of age in 1990 or later – the 90% factor is reduced to 40%. There is a phase-out of this provision if the worker has over 20 years of substantial earnings in a job where Social Security taxes were paid.
>
> The second provision, **government pension offset**, affects the Social Security benefits they might receive as a spouse or widow(er). This offset provides for a reduction of their Social Security spouse's or widow(er)'s benefits by two-thirds of the amount of their government pension. This provision was enacted to keep the spousal benefit in line with the intention of the Social Security program – that is to provide spousal benefits to those who are financially dependent on their husband or wife who worked at jobs covered by Social Security.

Social Security management strategies need to be formulated for different age groups:

- Younger Workers;
- Middle-Aged Earners;
- Those Approaching Retirement; and
- Those Applying for Benefits and Beyond.

<u>Case # 1:</u> Fred Farmer

Fred Farmer will be 64 the 1st of June 2004. Fred is a widower and his earned income has always been exactly the Old Age, Survivors, and Disability Insurance (OASDI) amount since 1955. Fred wants to retire sometime during the last six months of 2004 and begin drawing Social Security retirement benefits. Fred estimates his 2004 farming income could be either $30,000 or $90,000 depending on the amount of 2004 grain he sells following harvest. If he holds his income down to $30,000 his ending grain inventory will be $100,000; whereas his inventory will be $40,000 if he increases his income to $90,000.

<u>Selected Data from Benefit Calculator</u>: (based on earnings history through 2003 and retiring December 2004)

AIME = $5,716 PIA = $1,871 Monthly Benefit = $1,756

Total OASDI Taxes = $164,625

Lowest Three Annual Indexed Earnings (in high 35 years) are:
1955 $40,906 1969 $42,555 1966 $42,974

<u>Questions:</u>

1-1. Will Fred have to pay SE tax on the 2004 grain he sells after his retirement?

1-2. Will income from carryover grain be included in the income limitation test for 2005?

1-3. Should Fred retire and begin receiving SS retirement benefits in September or wait until harvest is completed and begin receiving SS retirement benefits in December?

1-4. Should Fred consider selling all of his inventory prior to retirement?

1-5. What is the monthly earnings test for Fred during retirement?

1-6. How many hours per month can Fred work after he retires and still qualify for SS retirement benefits?

<u>Questions and Answers:</u>

1-1. Will Fred have to pay SE tax on the 2004 grain he sells after his retirement?

Yes, self-employment income is counted when received not when earned.

1-2. Will income from carryover grain be included in the income limitation test for 2005?

No, if Fred informs SSA that he produced this grain prior to his retirement.

1-3. Should Fred retire and begin receiving SS retirement benefits in September or wait until harvest is completed and begin receiving SS retirement benefits in December?

If Fred completes the harvest prior to retiring – the grain not sold during the year of retirement will be "hold over" or carryover inventory and not count against his income limit.

1-4. Should Fred consider selling all of his inventory prior to retirement?

The real question is should Fred consider increasing his income from $90,000 to $130,000? Two major points to consider are the following. First, the only way Fred could avoid paying Social Security tax on his grain is if he increases his SE income to amounts greater than the maximum level for Social Security ($87,900 for 2004). Second, Fred's sells all of his grain prior to retirement – his income tax bracket would remain at 28%.

1-5. What is the monthly earnings test for Fred during retirement?

The monthly earnings test does not apply to self-employed individuals.

1-6. How many hours per month can Fred work after he retires and still qualify for SS retirement benefits?

The substantial hours of work test is normally 45 hours per month. Each month in the year of retirement is considered separately.

Glossary http://www.ssa.gov/glossary.htm

AIME (Average Indexed Monthly Earnings)	The dollar amount used to calculate your Social Security benefit if you attained age 62 or became disabled (or died) after 1978. To arrive at your AIME, we adjust your actual past earnings using an "average wage index," so you won't lose the value of your past earnings (when money was worth more) in relation to your more recent earnings. If you attained age 62 or became disabled (or died) before 1978, we use Average Monthly Earnings (AME).

Credits (Social Security Credits)	Previously called "*Quarters of Coverage*." As you work and pay taxes, you earn credits that count toward your eligibility for future Social Security benefits. You can earn a maximum of four credits each year. Most people need 40 credits to qualify for benefits. Younger people need fewer credits to qualify for disability or survivors' benefits. For more information read: *How You Earn Credits* (05-10072).

Delayed Retirement Credits (DRC)	Social Security benefits are increased (by a certain percentage depending on a person's date of birth) if retirement is delayed beyond full retirement age (FRA). Increases based on delaying retirement no longer apply when people reach age 70, even if they continue to delay taking benefits.

Early Retirement	You can start getting Social Security retirement benefits as early as age 62, but your benefit amount will be less than you would have gotten at full retirement age. If you take retirement benefits early, your benefit will be permanently reduced, based on the number of months you received checks before you reached full retirement age. See *Retirement Insurance Benefits* (RIB).

Family Benefits (Dependent Benefits)	When you're eligible for retirement or disability benefits, the following people may receive benefits on your record: • Spouse if he or she is at least 62 years old (or any age but caring for an entitled child under age 16) • Children if they are unmarried and under age 18, under age 19 and a full-time elementary or secondary student • Children age 18 or older but disabled • Divorced ex-spouse.

<table>
<tr><td>Payment Dates for Social Security Benefits</td><td>
If you filed for Social Security benefits before May 1, 1997, your payments usually are dated and delivered on the 3rd of the month following the month for which the payment is due. For example, payments for January are delivered on February 3rd.
If the 3rd of the month is a Saturday, Sunday or Federal holiday, your payments are dated and delivered on the first day before the 3rd of the month which is not a Saturday, Sunday or Federal holiday. For example, if the 3rd is a Saturday or Sunday, payments are delivered on the preceding Friday.
If you filed for Social Security benefits May 1, 1997, or later, you are assigned one of three new payment days based on the date of birth of the insured person:
<table>
<tr><th>If you were born on the…</th><th>Your payment will be delivered on the…</th></tr>
<tr><td>1st through 10th of the month</td><td>Second Wednesday of the month</td></tr>
<tr><td>11th through 20th of the month</td><td>Third Wednesday of the month</td></tr>
<tr><td>21st through end of the month</td><td>Fourth Wednesday of the month</td></tr>
</table>
If your scheduled Wednesday payment day is a Federal holiday, we’ll send your payment on the preceding day that is not a Federal legal holiday.
For a schedule of 2003 benefit payment dates, see http://www.socialsecurity.gov/pubs/2003calendar.htm
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PIA (Primary Insurance Amount)	The monthly amount payable if you are a retired worker who begins receiving benefits at full retirement age or if you're disabled and have never received a retirement benefit reduced for age.