8 Social Security Planning

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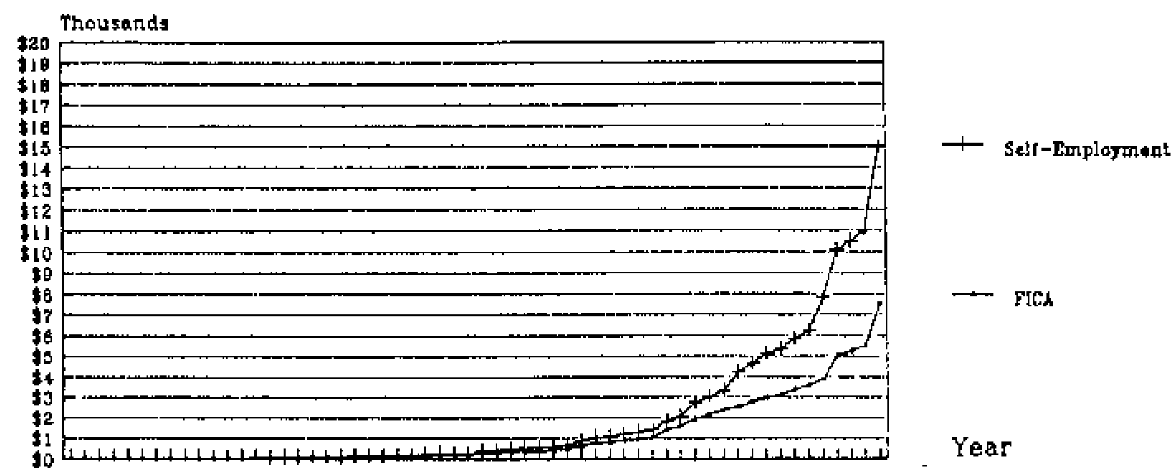
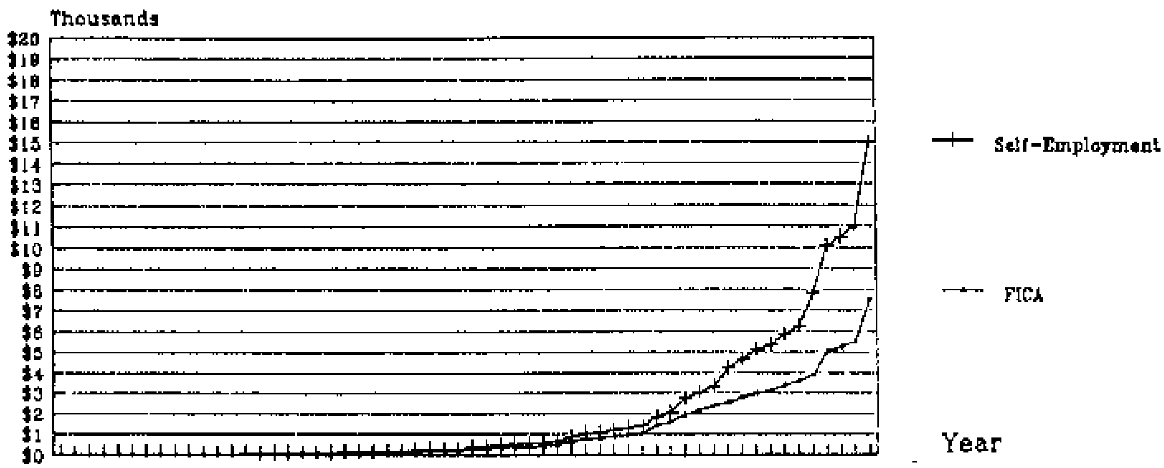
For farmers and self-employed business owners, Social Security has become the dominant tax. Since 1980, the potential self-employment tax contribution has more than quadrupled, reaching $10,000 for those paying at the Old Age, Survivor's, and Disability (OASDI) ceiling of $65,400 in 1997. (See Figure 1.) **When considering both halves of FICA, Social Security is the single largest tax liability for 74% of American taxpayers and 70% of individual taxpayers.**

Figure 1 Maximum FICA and Self-Employment Taxes Payable for 1937 through 1997**



**With the elimination of the medicare earnings ceiling, no maximum Social Security tax exists.



**With the elimination of the medicare earnings ceiling, no maximum Social Security tax exists.

In spite of this significance, Social Security remains a mystery to the vast majority of Americans. Tax professionals also show a singular lack of expertise in this vital subject area. To alleviate this problem, this chapter will focus on the statutory formulas involved in calculating Social Security benefits, and then build on this basic knowledge by focusing on appropriate strategies for the self-employed.

With a few exceptions, each of us begins making contributions to the system as soon as we earn wages or business profits. In many cases, we begin making contributions as teenagers and may continue to do so for as long as 50 years. Unfortunately, many contribute thousands of dollars in taxes that will never translate into benefits. **This occurs because, for individuals born after 1929, only the highest 35 years of indexed earnings may be used to calculate retirement benefits.**

Qualifying for Benefits

Before calculating benefits, one must identify what it takes to be eligible for various types of benefits. **To qualify for benefits, one must have enough quarters of earnings coverage (credits) to be "insured."** Social Security regulations provide two ways to be insured: **fully insured** and **currently insured.**

To qualify for retirement benefits, one must be fully insured. "Currently insured" is a qualification used for disability and other non-retirement benefits and will be discussed later under disability benefits. Figure 2 shows the quarters of coverage (also called credits) needed to be fully insured.

Figure 2 Quarters Needed to Be Fully Insured

Year of Birth	Quarters Needed to Be Fully Insured
1925	36
1926	37
1927	38
1928	39
1929 and later	40

Once the required number of quarters has been earned, the person is fully insured for life.

An alternative test exists to determine when younger workers are **fully insured.** If a worker has at least six quarters of coverage and has a quarter for each year after age 21 and before the year of death or disability, that worker will be fully insured. For example, if a person dies at age 35, at least 13 quarters (35– 21, not counting the year he or she turns 35) are needed to be fully insured. At no time, however, will a person ever be fully insured with less than six quarters of coverage.

Quarters of coverage are earned by posting earnings for the year in question in the following amounts (see Figure 3):

Figure 3 Earnings Needed for One Quarter

Year	Worker (FICA)	Farm Worker or Self-Employed (SE)	Year	Worker (FICA)	Farm Worker or Self-Employed (SE)
1977	$50	$100	1988	$470	$470
1978	250	250	1989	500	500
1979	260	260	1990	520	520
1980	290	290	1991	540	540
1981	310	310	1992	570	570
1982	340	340	1993	590	590
1983	370	370	1994	620	620
1984	390	390	1995	630	630
1985	410	410	1996	640	640
1986	440	440	1997	670	670
1987	460	460			

If a worker is fully insured, the following monthly benefits are available:

- Retirement benefits for the worker at age 62 or older.

When the worker is retired and receiving benefits, the following are available:

- Retirement benefits for the spouse of the worker at age 62 or older.
- Dependent benefits for the spouse of the retired worker if the spouse is caring for a child under age 16 or disabled.
- Dependent benefits for the unmarried children of the retired worker. Children must be under age 18 (or

under age 19 if full-time elementary or secondary school students).

At the death of the worker, the following are available:

- Survivor's benefits for widow(er) of worker at age 60 or older.
- Survivor's benefits for disabled widow(er) of worker at age 50 or older.
- Survivor's benefits for dependent parent of deceased worker.

Divorce

Benefits also are available to a divorced spouse, provided the spouse was married to the worker for at least 10 years. **Benefits for the divorced spouse are lost if remarriage occurs.** If again divorced or widowed, benefits based on the former spouse are **once again** available. One other difference between a current and divorced spouse is that the ex-spouse on whom benefits will be drawn does not need to be receiving benefits, **but need only to be old enough to receive benefits.**

Death of Spouse

A widow(er) is entitled to benefits with a much shorter qualification period—one year of marriage in the case of death from natural causes, nine months in the case of accidental death. Unlike for a divorced person, remarriage will not affect the benefits of a widow(er) if he or she remarries after she or he is entitled to benefits (at age 60).

Conversely, none of the above benefits are available if the worker is not fully insured.

In addition, a worker may be either fully or currently insured to qualify for these benefits:

- Survivor's benefits for a child of a deceased worker under age 18 (age 19 if full-time elementary or secondary school student).
- Survivor's benefits for widow(er) caring for a qualified child.
- Lump-sum death benefits to an eligible surviving widow(er) or child.

If a worker needs additional quarters to qualify for retirement, he or she may acquire them at any age.

Military Service

Military service may also be used to acquire coverage through "deemed military credits." Military personnel did not have FICA taxes deducted from their wages until 1957, but $160 a month may still be used for benefit calculations, and four quarters of coverage may be used for each year of military service after 1940 for purposes of becoming fully insured. Also, from 1957 through the present, a deemed military credit of $100 per month is available in addition to the actual FICA earnings; since 1967, Social Security has automatically included this credit in its benefit calculations.

Military service prior to 1967 is not shown on Social Security printouts of past earnings. A request

Military service prior to 1967 is not shown on Social Security printouts of past earnings. A request must be made to include either the earnings or the quarters in the calculations.

Computing Social Security Benefits

Computing a Social Security benefit is somewhat complicated, requiring a person's year of birth, date of retirement, and a year-by-year earnings history. It involves numerous calculations, which can be easily done using a computer.

Once the worker is determined to be fully insured, the first step in the process of calculating retirement benefits is to determine the worker's **computation years.** This number is extremely important because this is the number of years that may be used in calculating retirement benefits. Figure 4 shows the computation years for workers born in 1924 or later.

Figure 4 Years Used in Calculating Retirement Benefits

Year	Computation Years
1924	30
1925	31
1926	32
1927	33
1928	34
1929 and later	35

The next step is to make a list of "base years" and the worker's earnings for those years. The base years are those beginning in 1951 and ending with the year before the worker retires. These earnings cannot exceed the maximum earnings used for Social Security purposes. (See Figure 5.)

These earnings also were the top limits for Social Security taxes levied on either salary or earnings**except Medicare taxes, which have no ceiling.**

These earnings ceilings increase each year based on inflation, with the revised figures being released on October 15. A printout of earnings may be obtained from any local Social Security office, in person or by written request. When requesting a printout of an earnings history, be sure to specify a year-by-year history of earnings since work began. **One can also use Form SSA-7004 to get a printout of past earnings and benefits projections.**

This request results in receiving a Personal Earnings and Benefits Statement (PEBES). **Caution:** The benefits quoted are expressed in today's dollars and thus they may be significantly understated. The PEBES also avoids any discussion of indexing, which may be quite misleading. (See the following explanation.)

Figure 5 Maximum Creditable Earnings

Year	Earnings Ceiling	Year	Earnings Ceiling
1937–1950	$3,000	1982	$32,400
1951–1954	3,600	1983	35,700
1955–1958	4,200	1984	37,800
1959–1965	4,800	1985	39,600
1966–1967	6,600	1986	42,000
1968–1971	7,800	1987	43,800
1972	9,000	1988	45,000
1973	10,800	1989	48,000
1974	13,200	1990	51,300
1975	14,100	1991	*53,400
1976	15,300	1992	*55,500
1977	16,500	1993	*57,600
1978	17,700	1994	**60,600
1979	22,900	1995	**61,200
1980	25,900	1996	**62,700
1981	29,700	1997	**65,400

*The Revenue Reconciliation Act of 1990 raised the earnings ceiling for the Medicare portion of SE or FICA tax (2.9% and 1.45%, respectively) to $130,200 and $135,000, respectively, for 1991 to 1993.
**The Revenue Reconciliation Act of 1993 removes the earnings ceiling for Medicare taxes beginning in 1994.

Indexing

Indexing refers to the process by which earnings are leveled out to account for changes in the purchasing power of the dollar over a person's lifetime. Earnings are indexed using the worker's Social Security earnings for the year, the National Average Earnings constant for the indexing year—the second year before benefit eligibility (age 60 for retirees)—and the National Average Earnings constant for the year being indexed. The National Average Earnings figures used in indexing are also released each fall by the Social Security Administration. Unlike other variables released, these are two years behind because of the delay in tabulating the increases in earnings growth, which are the determining factors of increases in the National Average Earnings. **Figure 6 shows the National Average Earnings since 1951.**

Figure 6 National Average Earnings

Year	National Average Earnings	Year	National Average Earnings
1951	$2,799.16	1974	$8,030.76
1952	2,973.32	1975	8,630.92

1953	3,139.44	1976	9,226.48
1954	3,155.64	1977	9,779.44
1955	3,301.44	1978	10,556.03
1956	3,532.36	1979	11,479.46
1957	3,641.72	1980	12,513.46
1958	3,673.80	1981	13,773.10
1959	3,855.80	1982	14,531.34
1960	4,007.12	1983	15,239.24
1961	4,086.76	1984	16,135.07
1962	4,291.40	1985	16,822.51
1963	4,396.64	1986	17,321.82
1964	4,576.32	1987	18,426.51
1965	4,658.72	1988	19,334.04
1966	4,938.36	1989	20,099.55
1967	5,213.44	1990	21,027.98
1968	5,571.76	1991	21,811.60
1969	5,893.76	1992	22,934.42
1970	6,186.24	1993	23,132.67
1971	6,497.08	1994	23,753.53
1972	7,133.80	1995	24,705.66
1973	7,580.16		

The formula for indexing earnings is as follows:

$$\text{Worker's Social Security earnings for year being indexed} \;\; \pounds \;\; \frac{\text{National Average Earnings in indexing year (age 60)}}{\text{National Average Earnings in year being indexed}}$$

To illustrate the process of indexing, let's use the example of John Worker, who reaches age 62 and is considering retirement in 1997. John is married, and his spouse is one year younger than he is. He has been self-employed for 20 years, but not for his entire career. His spouse will draw benefits based on John's earnings. He is concerned with making the correct decisions regarding retirement, questions that will be dealt with later in this chapter.

Let's assume John Worker has the earnings history shown in Table 1.

NAME:	John Worker
YEAR OF BIRTH:	1935
INDEXING YEAR:	1995
COMPUTATION YEARS:	35

Earnings History					
Age	**Year**	**Creditable Earnings**	**Indexed Earnings**	**Indexing Factor**	**Eliminated Years**
16	1951	$ 384.00	$ 3,389.22	8.83	***
17	1952	3583.00	29,771.56	8.31	
18	1953	1,484.00	11,678.26	7.87	***
19	1954	2,247.00	17,591.87	7.83	***
20	1955	3,623.00	27,111.99	7.48	***
21	1956	4,200.00	29,375.20	6.99	
22	1957	4,200.00	28,493.07	6.78	
23	1958	4,200.00	28,244.26	6.72	
24	1959	4,800.00	30,755.53	6.41	
25	1960	4,800.00	29,954.11	6.17	
26	1961	4,800.00	29,017.40	6.05	
27	1962	4,800.00	27,633.68	5.76	***
28	1963	4,800.00	26,972.23	5.62	***
29	1964	4,800.00	25,913.22	5.40	***
30	1965	4,800.00	25,454.88	5.30	***
31	1966	6,600.00	33,018.52	5.00	
32	1967	6,600.00	31,276.35	4.74	
33	1968	7,800.00	34,585.87	4.43	
34	1969	7,800.00	32,696.30	4.19	
35	1970	7,491.00	29,916.41	3.99	
36	1971	7,407.00	28,165.70	3.80	
37	1972	8,063.00	27,923.65	3.46	***
38	1973	10,800.00	35,199.93	3.26	
39	1974	13,200.00	40,608.20	3.08	
40	1975	14,100.00	40,360.68	2.86	
41	1976	15,300.00	40,968.67	2.68	
42	1977	16,500.00	41,683.72	2.53	
43	1978	17,700.00	41,425.63	2.34	
44	1979	19,654.00	42,298.60	2.15	
45	1980	23,240.00	45,883.36	1.97	
47	1982	16,488.00	28,032.30	1.70	
48	1983	29,382.00	47,633.72	1.62	
49	1984	31,258.00	47,861.55	1.53	
50	1985	31,818.00	46,728.15	1.47	
51	1986	37,199.00	53,055.96	1.43	
52	1987	39,188.00	52,541.98	1.34	
53	1988	42,001.00	53,670.23	1.28	
54	1989	42,282.00	51,971.55	1.23	
55	1990	44,129.00	51,846.92	1.17	

56	1991	38,564.00	43,680.84	1.13	
57	1992	39,547.00	42,601.24	1.08	
58	1993	22,145.00	23,650.83	1.07	***
59	1994	23,650.00	24,597.98	1.04	***
60	1995	48,523.00	48,523.00	1.00	
61	1996	51,205.00	51,205.00	1.00	
Totals		$801,608.00	$1,628,472		

From the column totals, one can see that the actual earnings are more than doubled by the indexing process. With current moderate inflation levels, indexing will be less significant for future retirees, especially those entering the workforce after 1985.

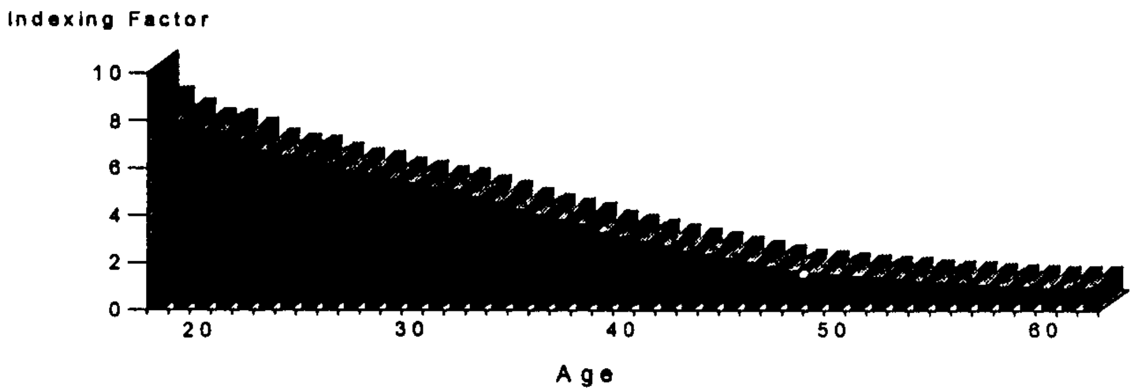
From Table 1, John had $7,800 credited to his earnings in 1969. And from Figure 6, the National Average Earnings in his indexing year (1995) were $24,705.66 and for 1969 were $5,893.76. Applying the indexing formula,

$$\begin{array}{c}\text{Indexed earnings}\\ \text{for 1969}\end{array} = \$7;800 \;\pounds\; \frac{\$24;705:66}{\$5;893:76} = \$32;696:30$$

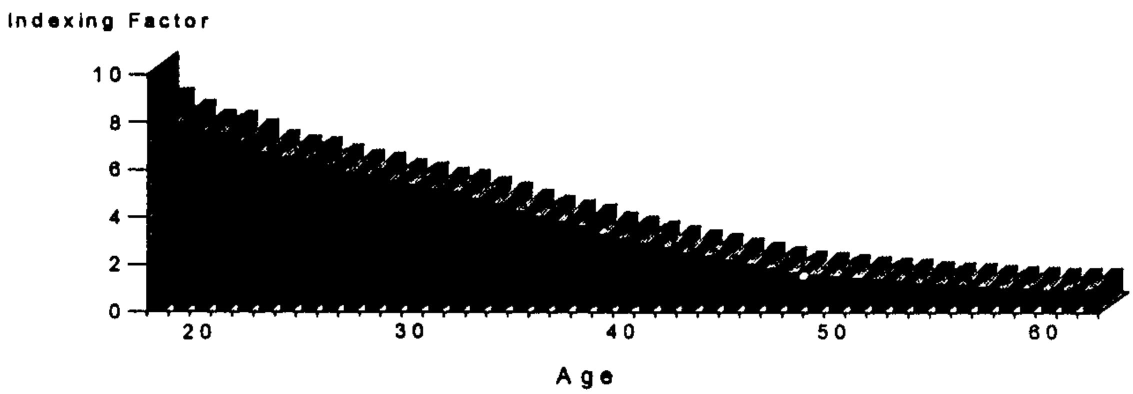
In the same manner, the Social Security earnings need to be indexed for each of the worker's base years, except that earnings for the years after the indexing year (age 60) are not indexed; these earnings are allowed to remain unchanged but, again, cannot exceed the maximum creditable amount. As Figure 7 shows, a dollar earned at age 20 may be worth as much as seven or eight times more than a dollar earned at age 60.

Figure 7 The Effect of Indexing on Earnings over a Person's Lifetime

THE EFFECT OF INDEXING ON EARNINGS OVER A PERSON'S LIFETIME



THE EFFECT OF INDEXING ON EARNINGS OVER A PERSON'S LIFETIME



A person's indexing year, should they become disabled or die before age 62, will be the year two years prior to death or disability.

Once each earnings year has been indexed, the lowest years are eliminated to the extent of reaching the worker's computation years. The earlier worker, reaching 62 in 1997, will have been born in 1935 and have 35 computation years. (See Figure 4.)

Next, total the indexed earnings for the 35 highest computation years. Typically, this total will amount to several hundred thousand dollars; for workers with very strong earnings histories, it will exceed a million dollars.

Divide the total indexed earnings by the number of months in the computation years. For our example, the total indexed earnings would be divided by 420 (35×12). **The result is the worker's Averaged Indexed Monthly Earnings (AIME).**

Remember, only John's 35 highest indexed earnings figures can be used, so this reduces the lifetime indexed earnings eligible for calculation from $1,628,472 to $1,412,247. Dividing this figure by 420 months, we get an AIME of $3,301. Once the AIME is calculated, there is one last step in determining the benefit due a person at age 65, also known as the Primary Insurance Amount (PIA).

For John, it involves the use of a formula that converts the AIME to PIA by adding the following:

- 90% of the first $455 or less of AIME
- 32% of any AIME above $455 to $2,741
- 15% of any AIME above $2,741

The points at which the brackets change from 90% to 32% to 15% are called **bend points,** or conversion thresholds. They are revised upward each year based on inflation. The **bend points used are for the year John Worker turns 62, in this case 1997.** [See Figure 8 for current and past bend points.]

Figure 8 Bend Points for Converting Earnings to Benefits (AIME to PIA)

Year of Eligibility (Age 62)	90%	32%	15%
1988	$319	$319.01--1,922	over $1,922
1989	339	339.01--2,044	over 2,044
1990	356	356.01--2,145	over 2,145
1991	370	370.01--2,230	over 2,230
1992	387	387.01--2,333	over 2,333
1993	401	401.01--2,420	over 2,420
1994	422	422.01--2,545	over 2,545
1995	426	426.01--2,567	over 2,567
1996	437	437.01--2,635	over 2,635
1997	455	455.01--2,741	over 2,741

In our example case, the $3,301 of AIME converts to a **PIA of about $1,225** ($455 \times .90$) + [($2,741 - 455$) $\times 0.32$] + [($3,301 - 2,741$) $\times 0.15$]. So if our worker retires at age 65, his monthly benefit will be $1,255.

Since he is retiring early, this is reduced by as much as 20% if he begins to draw at 62, or could increase by 6.0% for every year he defers retiring after age 65.

The reduction in benefits can also be calculated by multiplying 0.00555 times the PIA for each month the retiree draws benefits before age 65.

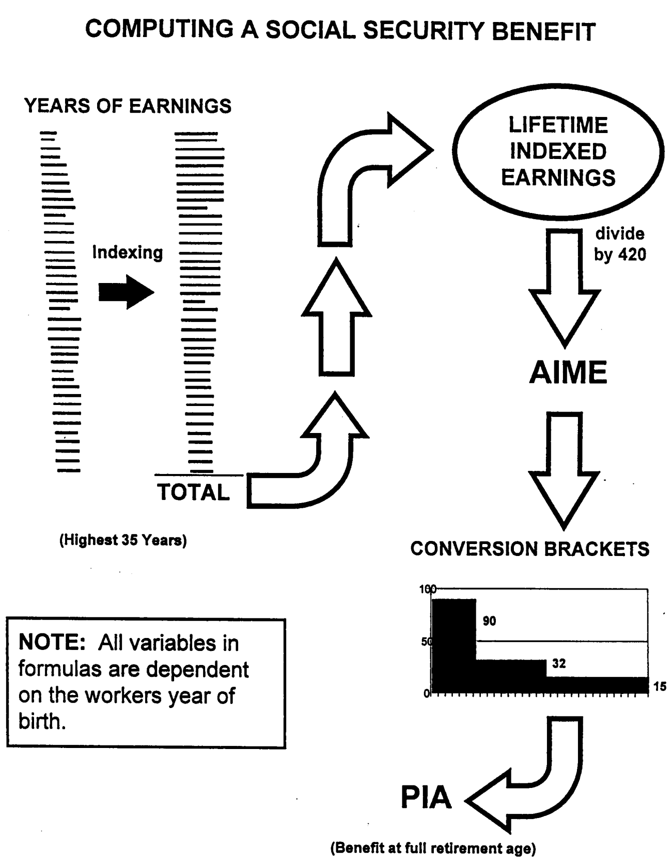
A spouse can also draw a benefit based on his or her spouse's PIA if he or she has no earnings history or if his or her earned benefit (PIA) is less than half of his or her spouse's. Following our example, if John's wife also turns 65 in 2001 and begins receiving benefits, her benefit amount would be $612.50, subject to adjustment if she begins drawing benefits at an age earlier than 65. For each month before age 65, a reduction of 0.003472 times the PIA will be made.

The bend points for converting AIME to PIA change every year. The thresholds used should be those from Figure 8.

Specific variables, chosen according to year of birth, must always be used. **Benefits cannot be calculated exactly until the bend points are released for the person's year of eligibility at age 62;** however, software is available that will project future benefits with acceptable accuracy.

The benefit calculation process is summarized in Figure 9.

Figure 9 Computing a Social Security Benefit



The formula in Figure 9 may seem fairly straightforward, and indeed it is. What makes ready comprehension difficult is the abundance of misconceptions being circulated and the fact that each of us interacts with Social Security differently according to the personal and economic variables that apply to us.

A recap of the "pressure-sensitive" parts of the benefit formula is in order. The following three portions of the formula have the greatest impact on determining which strategies will be effective:

1. **Indexing** is a huge influence on the worker's ability to inflate benefits at any given stage in his or her career. It is a negative influence on attempts to increase benefits just prior to retirement. It also makes a spouse with lower early earnings unlikely to ever overtake a spouse with strong, consistent, early and middle-age earnings. **In our example case,** John's wife, with little or no earnings, would require **approximately $400,000 of Social Security earnings** to match the spousal benefit she is already entitled to.
2. **The 35 years** of eligible earnings has a two-fold effect on strategy. **First,** the long period has the effect of diluting the influence of individual or small groups of years. **Second,** once the 35 years have been reached and exceeded, the incentive is very low to continue adding years as each new year forces the discarding of an earlier year, perhaps a very good one. In our example, John Worker has already discarded $216,225 of indexed earnings in the eleven eliminated years. The next posted year will discard $28,032 in earnings, or be discarded itself if lower.
3. **Finally, the three-bracketed formula** weights the earnings of lower-earning individuals more than those of higher earners. Obviously, this creates a disincentive for those with good earnings histories to add to them for purposes of increasing their Social Security benefit. Our example worker is in the 15% conversion bracket, making further contributions a low-return investment.

Practitioner Note.

Unless the above aspects of the Social Security benefit formulas are considered in plotting one's strategy, the strategy conceived will be faulty. Some **faulty beliefs** concerning Social Security are as follows:

- **Social Security benefits may be inflated significantly just before retirement.** This was true for those who retired before the present formulas were implemented (1979), but it is true today only for those with very meager earnings histories—those still in the 90% bracket.
- **Social Security benefits are accrued mainly in the latter part of one's working life.** In contrast, it is not uncommon to find forty-year-olds with 80% of their benefits accrued or fifty-year-olds with well over 90% of their benefits already earned. Indexing and the descending brackets in the conversion formula are the key reasons for this phenomenon. **In John Worker's case, the $545,074 of indexed earnings posted in the last decade only added $320 to his benefit.**
- **Diverting earnings to one's spouse is a sound move in the years before retirement.** Because of the indexing process, many homemakers have a break-even of $300,000 or more of earnings just to

achieve the benefit level they already are entitled to as a dependent spouse.

- **Social Security benefits are computed from a brief window of earnings—perhaps the highest five.** We now know the correct figure is **35.**
- **Social Security treats all of us the same.** Nothing could be further from the truth, and the disparity will grow. As our society counts the cost of funding Social Security for the baby boom generation, those who are more well off will see their benefits cut even more. Few individuals comprehend how each of us may receive more or less from Social Security because of our own particular personal and demographic variables, and the economic variables of the era in which we live our working lives and our retirements.

Following is a listing of the personal variables each of us possesses and the effect each has on the merits of posting further earnings:

- **Past earnings history—how much and when?** Greater past earnings decrease the incentive to post further earnings.
- **Earnings consistency—how many years of earnings?** If 35 years have been posted, or obviously will be, avoiding further earnings is a solid move if disability coverage is maintained.
- **Age—how soon will benefits start?** The closer one is to "pay dirt," the higher the return from Social Security taxes being paid.
- **Life expectancy—normal, greater, or less?** Obviously, if one lives longer, the investment returns from future Social Security taxes increase, roughly two percent for each five years.
- **Gender—this affects life expectancy.** Women, on the average, receive 55 to 60 more Social Security checks, making returns greater for them as a whole.
- **Marital status—and spouse's past earnings.** Dependent benefits are a built-in bias favoring the married, single-earner households.
- **Whether the husband and wife are close in age.** This variable is surprisingly neutral. Younger spouses receive greater widow's benefits, offsetting their delay in benefit receipt.
- **Inflation growth in the economy.** This variable may have a very positive effect for those not yet retired, especially if it comes 10 to 20 years before they retire.
- **The size of cost-of-living adjustments in benefits.** Higher increases obviously make Social Security returns better.
- **The opportunity cost for tax contributions compared to Social Security.** Higher investment returns in mutual funds or other investments make Social Security look bad.
- **The type of Social Security taxes the worker is subject to.**True FICA employees only pay half the bill, thus doubling their investment return.
- **Whether increased earnings will result in increased income tax.** If inflating one's self-employment earnings increases income tax as well, the move becomes a sure loser.

In the economic arena, the **effects of inflation** are the dominant influence on one's benefit level. History may prove that the most lasting effect of the 1974 Arab oil embargo will be on the Social Security checks of those retiring after the mid-1980s. Here is why: The numerator in the indexing formula is the National Average Earnings figure for the year retirees turn 60. The first five years of the new formula, 1979 to 1984, saw this numerator increase more than 40% while the denominator stayed frozen at average wage levels from the fifties, sixties, and seventies. This phenomenon is resulting in tremendous windfalls for Social Security beneficiaries in the last two decades of the twentieth century. They paid most of their taxes at low rates on low earnings ceilings relative to today's and received indexing for their pre-1979 earnings as much as 40% greater than their children will for the comparable life stage.

Social Security, in its retirement publication No. 05-10035, **supplies** estimated benefits for individuals retiring at ten-year intervals over the next 20 years (see Table 2):

Table 2 Approximate Monthly Benefits If You Retire at Full Retirement Age and Had Steady Lifetime Earnings

		Your Earnings in 1996				
Your Age in 1996	**Your Family**	**$20,000**	**$30,000**	**$40,000**	**$50,000**	**$62,700 or More[1]**
45	You	$ 797	$1,063	$1,229	$1,354	$1,519
	You and your spouse[2]	1,195	1,594	1,843	2,031	2,278
55	You	797	1,063	1,226	1,327	1,435
	You and your spouse[2]	1,195	1,594	1,839	1,990	2,152
65	You	805	1,074	1,205	1,272	1,326
	You and your spouse[2]	1,207	1,611	1,807	1,908	1,989

[1]Earnings equal to or greater than OASDI wage base from age 22 through the year before retirement.
[2]Your spouse is assumed to be the same age as you. Your spouse may qualify for a higher retirement benefit based on his or her own work record.
Note: The accuracy of these estimates depends on the pattern of your actual past earnings and on your earnings in the future. Your actual benefit probably will be higher because these estimates are shown in today's dollars.

It is important to remember that the benefit amounts received by survivors and dependents are all determined as a percentage of the PIA, or normal retirement benefit, for the worker at full retirement age.

Figure 10 shows the percentage of this benefit that may be received by various related individuals. Remember these amounts may also be limited by maximum family benefits.

Figure 10 Benefits Received as a Percentage of PIA

Type of Benefit	Percentage of PIA
Retirement benefits	
At normal retirement age (now 65)	100% of PIA
At age 62	80% of PIA

Spouse or qualifying divorced spouse at normal retirement age or caring for qualified child	50% of PIA
Spouse or qualifying divorced spouse at 62	37.5% of PIA
Child of retired or disabled worker	50% of PIA
Survivor's benefits	
Widow(er) or qualifying divorced spouse at normal retirement age	100% of PIA
Widow(er) or qualifying divorced spouse at age 60	71.5% of PIA
Widow(er) or qualifying divorced spouse at age 62	82.9% of PIA
Qualifying child	75% of PIA
Surviving parent caring for qualifying child	75% of PIA
Disabled widow(er) or qualifying divorced spouse age 50 to 60	71.5% of PIA
Dependent parent of deceased worker (one)	75% of PIA
Dependent parent of deceased worker (two)	82.5% of PIA
Lump-sum death benefit	
Qualifying surviving spouse or child	Lump sum $255
Disability benefits	
Worker	100% of PIA
Spouse caring for qualifying child	50% of PIA
Qualifying child	50% of PIA

Note that some individuals qualify for benefits under more than one status. For example, a spouse may be insured for his or her own benefits and also qualify for spousal benefits. In a case like this, an individual can only receive the equivalent of the higher benefit.

Disability Benefits

An overlooked and underrated area of Social Security is that of disability benefits. A person under age 40 is more than three times as likely to become disabled as they are to die. When one considers the added hazards to farmers compared to the population as a whole, this figure increases to more than five times the likelihood.

For Social Security purposes, "disability" is defined as any disabling condition that will last 12 months or more or is expected to end in death. Unless the disability is obvious, it is often difficult to qualify for these benefits; however, a substantial number of people who are initially turned down eventually qualify, so persistence can pay off.

Practitioner Note.

Social Security disability benefits are the best buy in the insurance marketplace today. In 1996, as little as $392 a year in self-employment taxes ($410 in 1997) could purchase four quarters of coverage that could potentially pay benefits until death. To let this coverage lapse is a serious mistake. The Social Security income required for four quarters is $2,680 for 1997.

One CPA firm in western Iowa was sued for malpractice by a client who lost disability coverage after instituting moves recommended by the firm (commodity wages from a C corporation).

The disability trust fund is a separate entity funded by 1.75% of the 15.3% Social Security tax. A shortfall in this fund has recently been balanced by increasing the funding percentage from 1.2%, lowering the old age and survivor's contribution by the same amount.

Social Security, in publication No. 0510029, **outlines the work credits needed to be currently insured for disability benefits:**

The number of years of work credits needed for disability benefits depends on your age when you become disabled.

Before 24—You need 6 credits in the three-year period ending when your disability starts.

24 through 31—You need credit for having worked half the time between age 21 and the time you become disabled.

31 or older—You need the amount of credit shown in Figure 11, and you generally must have earned at least 20 credits in the 10 years immediately before you become disabled. You also need to have as many total work credits as you would need for retirement.

Figure 11

Born After 1929, Become Disabled at Age	**Credits You Need**
31 through 42	20
44	22
46	24
48	26
50	28
52	30
53	31
54	32
55	33
56	34
57	35
58	36
59	37
60	38
62 or older	40

Exception: If you are disabled by blindness, the required credits may have been earned at any time

after 1936; you need no recent credit.

- As one can see, a young worker can qualify for disability benefits with as little as 18 months (6 quarters) of earnings.
- In 1996, the average monthly benefit for a disabled worker was $665, while the average family benefit for the disabled worker and dependents was $1,119. This increased in 1997 to $707 and $1,169, respectively.
- Figure 12 shows the approximate monthly benefits a disabled worker with various earnings and family sizes would receive if disabled in 1997.

Figure 12 Approximate Monthly Benefits if You Become Disabled in 1997 and Had Steady Earnings

		Your Earnings in 1996				
Your Age in 1997	**Your Family**	**$20,000**	**$30,000**	**$40,000**	**$50,000**	**$62,700 or More[1]**
25	You	$797	$1,063	$1,229	$1,354	$1,508
	You, your spouse and children[2]	1,195	1,595	1,844	2,032	2,262
35	You	797	1,063	1,229	1,354	1,485
	You, your spouse and children[2]	1,195	1,595	1,844	2,032	2,227
45	You	797	1,063	1,229	1,348	1,445
	You, your spouse and children[2]	1,195	1,595	1,844	2,023	2,168
55	You	797	1,063	1,214	1,297	1,363
	You, your spouse and children[2]	1,195	1,595	1,822	1,945	2,044
64	You	790	1,054	1,182	1,248	1,301
	You, your spouse and children[2]	1,185	1,581	1,773	1,872	1,951

[1]Earnings equal to or greater than the OASDI wage base from age 22 through 1996.
[2]Equals the maximum family benefit.
Note: The accuracy of these estimates depends on the pattern of your earnings in prior years.

For purposes of other benefits, such as benefits for a child or parent, or the lump-sum death benefit, "currently insured" is defined as having at least six quarters of coverage during the 13 quarters prior to death or disability.

Practitioner Note.

As one can see, the potential benefits far outweigh the costs, especially if the earnings are low and the person is young. As already stated, it is a very serious mistake for a farmer or anyone else to let this coverage lapse, yet many young farmers are in this position. Consider the following examples:

Example 1. Mary, age 31, is a progressive young farmer who has gradually purchased the family farm over the last five years. She is married and has four young children. Because of high depreciation deductions and costs associated with starting the business she has not shown any Social Security earnings for four years. With her college years included, she has only 12 quarters of coverage since age 21. She is not insured for disability, yet is exposed to farm machinery and other hazards on a daily basis. In 1995, she posted a profit and acquired four more credits, but still is four short of being currently insured.

In this case, our advice was to amend her 1993 and 1994 returns to use the optional self-employment earnings method. In this way, she gained $1,478 of earnings and acquired two credits for each year. (Note: Between 1985 and 1990, electing the optional self-employment earnings was only enough to earn three quarters, and since 1991 it has only been enough for two quarters.) The cost to Mary was $488 plus interest for the two years, but she would otherwise have been without disability protection for at least two more years. **Note:** These returns could only be amended three years after the original due date. The amending was done in 1995; 1996 would have been too late for amending a 1992 return if filing the amendment after April 15.

Example 2. In a more tragic example, Clarence, a bachelor farmer of 53, was diagnosed in 1993 with prostate cancer. Surgery found that the cancer had spread, confronting him with his mortality. His problem: With minimal earnings in the past ten years, he had 17 of the past 40 quarters, not enough to entitle him to disability benefits. His farm assets disqualified him for SSI, plus adding back his depreciation put his income over the Medicaid qualifying level. His only solution was selling the farm, a high price to pay for not using the optional self-employment provision. **Clarence was able to draw benefits 18 months later, based on two years of profits, but died after receiving only 13 Social Security checks.**

The solution to these problems for the self-employed is the optional method available for reporting self-employment income. This allows the taxpayer to pay self-employment taxes on $1,600 (actually $1,478 after adjustment). Doing so posts the needed quarters to retain disability coverage. **If the taxpayer is a Schedule C filer, profits of at least $400 are needed for the business in prior years, and the election is limited to five times during the owner's lifetime.** Farmers have no such limitations, other than having at least $2,400 of gross income and a net loss on Schedule F. Using the optional self-employment method will only add two quarters to the individual's earnings history, making it necessary to use this option each year if losses persist. One final note—making this election often does not result in paying the $244 of Social Security tax because it may trigger a higher Earned Income Credit. This occurs because the $1,600 is substituted into the Earned Income Credit formula, replacing the farm or business loss.

Survivor's Benefits

According to the Social Security Administration, **almost 20% of the 43 million** people receiving Social Security checks get survivor's benefits. These include 5½ million widows and close to 3 million children. In publication No. 05-10084, an example shows the potential significance of such benefits:

Consider a worker who died in 1990 at age 35, earned about $35,000 in 1989, and had an average earnings pattern before then. His survivors are his wife and two children, ages 8 and 10. By the time the youngest child reaches 18, this family would receive $177,000 in Social Security benefits, and this does not include any future cost-of-living increases. Figure 13 gives approximate survivor's benefits under different situations.

Figure 13 Approximate Monthly Survivor's Benefits if the Worker Dies in 1997 and Had Steady Earnings

		Deceased Worker's Earnings in 1996				
Worker's Age	**Worker's Family**	**$20,000**	**$30,000**	**$40,000**	**$50,000**	**$62,700 or More**[1]
35	Spouse and 1 child[2]	1,194	1,594	1,844	2,032	2,240
	Spouse and 2 children[3]	1,459	1,874	2,152	2,371	2,614
	1 child only	597	797	922	1,016	1,120
	Spouse at age 60[4]	569	760	879	968	1,067
45	Spouse and 1 child[2]	1,194	1,594	1,844	2,030	2,184
	Spouse and 2 children[3]	1,459	1,874	2,152	2,370	2,549
	1 child only	597	797	922	1,015	1,092
	Spouse at age 60[4]	569	760	879	968	1,041
55	Spouse and 1 child[2]	1,194	1,594	1,822	1,944	2,044
	Spouse and 2 children[3]	1,459	1,874	2,126	2,270	2,385
	1 child only	597	797	911	972	1,022
	Spouse at age 60[4]	567	760	868	927	974

[1]Earnings equal to or greater than the OASDI wage base from age 22 through 1996.

[2]Amounts shown also equal the benefits paid to two children, if no parent survives or surviving parent has substantial earnings.

[3]Equals maximum family benefit.

[4]Amounts payable in 1996. Spouses turning 60 in the future would receive higher benefits.

Note: The accuracy of these estimates depends on the pattern of your earnings in prior years.

Social Security Strategies

A self-employed person with above-average earnings could easily pay $500,000 in Social Security taxes over his/her lifetime. One might say, "There's nothing I can do about paying in that money; I have no other choice." For most workers and some self-employed individuals, this is true. But for farmers and many other self-employed persons, the opposite is true—how much is contributed and, thus, what one's benefit will be upon retirement, is controllable and can be managed. In order to do this correctly, a strategy must be developed that takes into account all those variables specific to each person.

A strategy is an "action plan." A Social Security action plan should include the following elements:

- A strategy for further contributions—contribute more, less, or hold to present levels.
- A plan to minimize loss of earnings through accumulation of excess computation years.
- A strategy for keeping disability coverage in place regardless of Social Security income.
- A strategy for one's spouse that is designed to optimize benefits.
- A decision to draw benefits at age 62, 65, or some other age.
- A plan to reduce involvement in the business in accordance with Social Security regulations.
- An integration of these issues with related questions such as family farm or business successions, estate planning, entity formation, or ongoing management strategies.

These issues need to be explored for two main reasons: to ensure a smooth transition into retirement and to exercise some control over Social Security tax contributions—potentially many thousands of dollars. **Let's examine each of the strategic elements listed above in more detail.**

To follow the earlier example of John Worker, let's add an additional year of $50,000 of earnings to John's history and gauge the consequences. Computing the benefits before and after, we see a **combined benefit increase of $12 a month retiring at age 65,** and **$9 a month retiring at age 62.** The tax paid will be $7,064.78. Projecting these increases out over our couple's lifetime and putting them into today's dollars, we find the following: Conclusions are generated by Social Security Analysis software, copyright 1991–1997, Woltjer & Associates.

Retirement Age	Additional Lifetime Value of Benefits in Today's Dollars	Additional Costs in Today's Dollars*
62	$1,673	$6,665
65	$1,620	

*Discounted at 6% for up to one year because taxes are usually paid March 1 of the following year. Taxes to be paid in later years are also discounted at 6%. Additional income taxes are not included on the earnings because in many cases the form of earnings is shifted to produce or maintain the increase.

Return on future Social Security tax if retiring at age 62	–5.69%
Return on future Social Security tax at full retirement age	–4.71%

The following pages outline the position of John Worker in more detail and recommend strategies for him to consider as he approaches retirement.

Conclusions for John Worker

Returns. Your present Social Security tax contributions are showing a –5.7% return, based on the assumptions mentioned earlier. You will have to compare this return with what you could get from other safe investment alternatives and adjust your Social Security earnings to reflect your decision. If you do reduce your Social Security contributions, your best strategy would be to invest the tax savings in pre-tax investments.

Years of Earnings. After the current year, you have paid Social Security taxes on 46 years of earnings. This is significant because you can use no more than 35 years of earnings in calculating your benefits, with each year beyond eliminating the lowest year in your earnings history. Presently, the lowest year not yet eliminated in your earnings history is $28,032. **Any elimination will lower returns from future Social Security taxes.**

Disability.**One consideration to watch in this process is your disability coverage.** To maintain this, you need to have Social Security Coverage from 20 of the last 40 quarters prior to disability. You now have 40 out of the last 40. If you reduce your Social Security earnings, be sure to do so in a way that keeps this coverage intact. For 1996, you need $2,560 of SE or FICA earnings to earn the four possible quarters.

Spouse's Benefits. Your spouse's benefits, based on her own earnings history, would be less than half of yours, so her benefits will be based on your earnings. **Your spouse would need future Social Security earnings of $443,439 to bring her benefit up to half of yours, so this may not be a realistic option.** Therefore, additional earnings on your part will raise her benefits as well as yours. Benefits quoted are for both.

Early Retirement.**Our analysis further shows an advantage financially to retiring at age 62.** By retiring at age 62, your benefits would be reduced by $398 per month, but the years of benefits up front would amount to $51,804. The breakeven for recovering this amount will be about 10.8 years. Consider also that dollars received 10 to 20 years in the future won't be worth as much as dollars received sooner (see previous page).

Retirement Qualifications. You will have to consider Social Security's requirement of reduced involvement for retirees when you make your retirement decision. These requirements include both reduced work (they generally say less than 45 hours per month) and less management of the day-to-day business. Earnings restrictions also limit the amount of wages or business profits to $8,640 for those under 65 and $13,500 for those aged 65 but under 70. These limits are increased each year, but more significantly for those 65 and older, **who may make up to $30,000 in the year 2002 and beyond.**

Each section of the conclusions merits elaboration in the following discussions:

Further Contributions

The decision on how much Social Security earnings to post is an extremely complex one. If this is analyzed in a comprehensive manner, all of one's personal, demographic variables (see page 346) need to be considered, plus some assumptions on inflation and opportunity costs must be made.

An analysis that will produce the costs and returns listed at the end of the conclusions profile is calculated by the following steps:

1. Calculate the tax contributions to Social Security for the future earnings to be posted.
2. Reduce these costs to their present value using a conservative investment return as the discount rate (4 to 8% is typical). We used 6%.
3. Calculate the future increase in benefits from adding the contemplated earnings.
4. Summarize the benefit increases from eligibility through the end of normal life expectancy. If a dependent spouse is involved, include his or her benefits as well. Reduce these benefit streams to present value using the same discount rate as in Step 2.
5. Using the present value of the tax costs as the amount invested and the benefit increases as the return, calculate the internal rate of return for the tax contributions in question.

This is an extremely sophisticated financial analysis, but can be accomplished using advanced spreadsheet functions. The rate of return is almost always identical for varying levels of future earnings.

Two exceptions to this rule are (1) when prior years of earnings are being eliminated, and (2) when future earnings pass a bend point in the formula.

This last case is infrequent because the 32% formula bracket is so broad—$960,120 of indexed earnings for a new retiree in 1996, increasing to almost $3,000,000 for someone in his or her twenties today. Therefore, one year of $10,000 future earnings may show the same return as 10 years at $50,000 per year, especially for a person with low to moderate past earnings.

In the case of John Worker, our advice to John would be as follows:

Returns. *Your present Social Security tax contributions are showing a -5.7% return, based on the assumptions mentioned earlier. You will have to compare this return with what you could get from other safe investment alternatives and adjust your Social Security contributions to reflect your decision. If you do reduce your Social Security contributions, your best strategy would be to invest the tax savings in pre-tax investments.*

The assumptions are as follows:

- Age 61, will be 62 in December
- Spouse age 60, will receive dependent benefits
- Social Security earnings began in 1951 (see Table 1)
- Normal life expectancies for both taxpayer and spouse
- 4% inflation, a 6% discount rate for future costs and returns
- Social Security taxes paid as self-employed

Obviously, the conclusion is to terminate further tax contributions, if possible. To show the effects of various variables, consider these potential changes in John Worker's present return of–5.7%.

- If he were single, his return would drop to –11.9%.

- If he were single and female, the return would be –7.2%.
- If his life expectancy is five years less, the return is –10.9%.
- If his life expectancy is five years more, the return is –2.6%.
- If we use a discount rate of 4%, the return is –5.75%.
- If we use an inflation rate of 3%, the return is –6.5%.
- If John were a true FICA employee, his return would be +0.5%.
- If John had less than 35 years of earnings, his return would be 0.6%.

Each of these variations assumes that the other variables are left in their original selections. Various combinations of these variables will produce even greater variations in potential returns from future taxes.

In John Worker's case, the key reasons his returns are so poor are

- He is eliminating 11 prior years of earnings.
- He is self-employed, paying the full tax rate.
- His current conversion bracket is 15%.

The biggest plus he has going for him is a dependent spouse who will receive up to half of his benefit. If John had lower earnings, fewer years of earnings, and a FICA position, his returns could be as high as 13%.

Minimizing Loss of Computation Years

Returns will surely drop to some degree if lower earnings years from the past are eliminated by new earnings years. Knowing how close one is to the maximum number of years will allow one to set goals and establish a plan for the remaining years prior to retirement. Reporting alternative years of self-employment earnings is one potential solution.

For example, two years of $15,000 (Schedule C or F profits) maybe lumped together as one year of $30,000. With enough other income to apply to the standard or itemized deductions and exemptions, both scenarios may be taxed at 15% of the federal rate. More drastic moves to prevent elimination of past years may include selling the business, renting out business property, forming an entity, or early retirement.

Obviously, these moves have other consequences to be considered, but may be worth considering if one's last five years of earnings prior to retirement eliminate five prior high years (potentially up to $150,000 of indexed earnings).

In our example, our advice to John would be as follows:

Years of Earnings. *After the current year, you have paid Social Security taxes on 46 years of earnings. This is significant because you can use no more than 35 years of earnings in calculating your benefits, with each year beyond eliminating the lowest year in your earnings history. Presently, the lowest year not yet eliminated in your earnings history is $28,032. Any elimination will lower returns from future Social Security taxes.*

Not surprisingly, this example produces a negative return, meaning the tax costs **will not be recovered** during normal life expectancy.

Keeping Disability Coverage

A reason not to report several consecutive years of zero earnings is the potential loss of disability coverage. This danger lessens as retirement age approaches. For example, those aged 57 can show five years of zero earnings provided they had five consecutive years of sufficient earnings immediately before age 57 and plan to retire at age 62.

Disability coverage for John is not a problem, as our advice shows:

Disability. *One consideration to watch in this process is your disability coverage. To maintain this, you need to have Social Security coverage from 20 of the last 40 quarters prior to disability. You now have 40 out of the last 40. If you reduce your Social Security earnings, be sure to do so in a way that keeps this coverage intact. For 1997, you need $2,640 of SE or FICA earnings to earn the four possible quarters.*

For a younger worker or one with erratic earnings, this could be a factor to watch.

Spouse's Strategy

The status of one's spouse strongly affects one's own strategy toward Social Security. Whether the spouse will draw benefits from his or her own earnings history or benefits based on a spouse's higher earnings is one of the **top four factors** influencing returns from future tax contributions. (The other three are whether past years are being eliminated, the conversion bracket, and whether self-employment or FICA tax is being paid.)

To review, if a spouse's benefits from his or her own earnings history are less than half of the other spouse's, he or she will receive half of his or her spouse's benefits (or 37.5% at age 62). Many younger couples today form two-earner households, unlike their parents, who are now approaching retirement. Social Security has a built-in bias against two-income households; therefore, if a couple can concentrate their earnings on one spouse's earnings history, they will overcome this bias.

This concentration is possible mainly for couples operating a small business or farm together. For these couples, there is no statistical possibility of splitting an earnings history and increasing their combined benefits. In spite of this truth, a potential trap exists for young couples in this position who have not been married ten years—divorce.

In an early divorce, the spouse claiming the earnings may see a tremendous advantage over the other spouse in regard to Social Security, especially with significant earnings in one's twenties when indexing is so pronounced.

This author's approach to developing a spouse's strategy is based on the answers to these questions:

- Has the couple been married ten years?
- Has the spouse already built up a significant earnings history?
- If not, what are the odds of the spouse accruing a benefit equal to half that of the higher-earning spouse?
- How old are the individuals in question?
- Is there an age disparity between them? Who is older?
- If the spouse with the lower earnings history becomes disabled, what will the impact on the family be?

To illustrate how these questions are examined in developing strategy, consider the following example: John and Mary are engaged in a business together with $70,000 of annual profit. They are both 42, having been married later in life, but more than ten years ago. John has a projected PIA at age 66 of $625, while Mary's comparable benefit is $400. From the rules, we see that both will draw on their own benefit and, unlike most workers past age 30, are both still in the 90% conversion bracket, having both been in a religious order until age 31.

To calculate the breakeven for John to double Mary's benefit, the Social Security formula is figured backwards. For John to double Mary's benefit, he would need to bring his benefit up to $800, an increase of $175. To translate this increase into earnings, we would divide by .9, multiply by 420, and adjust the earnings upward by about 2.2 times to account for indexing. The result of these calculations is $179,667.

To decide how to allocate the earnings, simply evaluate the probability of John acquiring this amount of self-employment earnings in excess of Mary's self-employment earnings before retirement. We can see that this will be accomplished in less than three years, so lacking any other influencing factor, they should put the earnings in John's name, with the result that Mary draws as a dependent spouse. She should, however, be sure to post enough in wages to keep her disability coverage intact. Instituting a Section 105 Medical Benefit Plan for Mary would be an excellent option, making this decision even better.

Let's piece together strategies for spouses of various ages, considering the preceding factors.

For young couples, where one spouse is showing all of the earnings from a business, it is a very valid move to shift some cash earnings through a wage to the other spouse. Aside from the divorce issue, several other reasons exist:

- To keep the spouse's disability coverage
- To qualify the spouse for fringe benefits or an IRA (not needed after 1996), SEP, SIMPLE, KEOGH, or other pension contribution
- To keep intact survivor's benefits for young children should the spouse die

It makes much more sense to shift earnings or pay a wage to a spouse under age 55 than to do the same for an older spouse, but we should evaluate each situation for its merits.

However, for couples in their fifties, two more reasons for shifting earnings arise:

- If the prospects that a spouse will draw on his or her own history are great, that spouse may well show a better return than the spouse with higher earnings. This may happen because of differences in life expectancy between the sexes, the possibility of the higher-earning spouse eliminating prior years of earnings, or age differences.
- If the lower-earning spouse is several years older than the higher-earning spouse, paying the lower-earning spouse a wage may allow him or her to draw on his or her own earnings history until the higher-earning spouse retires.

Practitioner Note.

For couples in their forties, fifties, or early sixties, shifting earnings, other than in minimal amounts for disability coverage, pensions, and so on, is frequently an ill-advised move. Many farmers and business owners in this category have already accrued $700,000 to $1,000,000 of indexed earnings while their spouses may have under $100,000. With indexing much diminished at this point, the possibility of the lower-earning spouse reaching a benefit level of half the higher-earning spouse may be extremely remote. For individuals in this category, shifting earnings will result in wasted Social Security taxes because no increase in benefits will result. Evaluate the respective spouses' earnings histories and benefit projections closely to avoid this mistake. John Worker's wife fits this profile, as is shown in the following advice:

Spouse's Benefits. *Your spouse's benefits, based on her own earnings history, would be less than half of yours, so her benefits will be based on your earnings. She would need future Social Security earnings of $443,739 to bring her benefit up to half of yours, so this does not appear to be a realistic option. Therefore, additional earnings on your part will raise her benefit as well as yours. Benefits quoted are for both.*

The preceding situation fits many couples approaching retirement today. **It will differ sharply for younger couples,** two-thirds of whom are both employed.

Age 62 vs. Age 65 Retirement

Conventional wisdom on early retirement says take the money early. More than 70% of Americans receive their first Social Security check before age 65. In a vast majority of cases, this is the correct move from a pure benefit standpoint. The advice below to John Worker gives the numeric comparisons involved in the two benefit options:

Early Retirement. *Our analysis further shows an advantage financially to retiring at age 62. By retiring at age 62, your benefits would be reduced by $398 per month, but the years of benefits up front amount to $51,804. The break-even for recovering this amount will be about 10.8 years. Consider also that dollars received 10 to 20 years in the future won't be worth as much as dollars received sooner.*

The normal break-even time needed to recoup the three years of benefits varies from 10 to 14 years. When the time value of money is added to the calculations, those who retire early show a higher lifetime value of benefits than those retiring at age 65, assuming normal life expectancies.

In some situations, early retirement is not possible or may be ill-advised. These include

- A high salary must be sacrificed for a much lower Social Security benefit.
- Workers who would lose their health coverage by terminating their employment before Medicare eligibility.
- The high probability of paying back benefits by exceeding the earnings limit.
- The benefits becoming taxed at 50 or 85%.
- The self-employed person is unwilling or unable to meet Social Security requirements for reduced work involvement.

Reduced Involvement

Our advice to John Worker highlights a common dilemma:

Retirement Qualifications. *You will have to consider Social Security's requirement of reduced involvement for retirees when you make your retirement decision. These requirements include both reduced work (they generally say less than 45 hours per month) and less management of the day-to-day business. Earnings restrictions also limit the amount of wages or business profits to $8,640 for those under 65 and $13,500 for those aged 65 but under 70. These limits are increased each year, but more significantly for those 65 and older, who may make up to $30,000 in the year 2002 and beyond.*

Local offices vary a great deal in how strict they are on these provisions. One Social Security office manager in western Massachusetts has been known to drive past the farms of those receiving benefits or quiz neighbors on how much the retired farmer is working. Another East Coast office has many of their retiring farmers complete a lengthy questionnaire on their involvement in the business. Questionnaire responses then serve as a basis of comparison for later verbal interview questions. On the other hand, some offices have been known to allow farmers to draw benefits without changing their involvement at all, provided their earnings did not exceed the limits for benefit reduction. **With multi-generation farmers, the key to avoiding trouble when applying for benefits is to begin to make moves toward less involvement at least two years prior to retirement.** Then, if a person's involvement is questioned, tax returns can be produced that show what is happening.

Practitioner Note.

Earnings limitations for 1997 are $8,640 for ages 62 through 64 and $13,500 for ages 65 through 69. For those under 65, benefits are reduced one dollar for each two dollars of earnings over the allowed limits, while for those 65 through 69, only one dollar for every three excess dollars earned will be deducted from benefits. For **wage earners** in the year of retirement, earnings are considered on a month-by-month basis with benefits affected only in months exceeding one-twelfth of the allowed earnings—$720 for ages 62 through 64 and $1,125 for ages 65 to 69 in 1997. For the **self-employed,** benefits, in the first calendar year of retirement, may be received for any month in which they do not work more than 45 hours, even if self-employment earnings for the year exceed the allowable limit.

In the year a person reaches 70, the earnings limit is also prorated monthly for those months before the worker's 70th birthday. Any month in which this monthly limit is met will see the full benefit paid, even if the annual limit is exceeded for the calendar year. Of course, after reaching age 70, no earnings limits apply.

Social Security Impacts on Family Successions

Ideally, the transfer of farm or small business assets to the next generation will begin well before retirement approaches. Social Security plays a key role in these transitions, both from a tax-planning standpoint and in meeting the requirements for drawing benefits.

Family business or farm successions may present tremendous opportunities for shifting active income to passive status:

- The younger generation may form an entity, such as a partnership, which rents real estate or other assets from the senior generation. Watch active involvement rules, or self-employment tax may apply.
- The younger generation may rent assets from the parents without the involvement of an entity.
- Assets may be sold to the younger generation, resulting in principle and interest payments instead of profits.
- Special partnership rules may allow the senior partner to draw out his or her basis in the partnership free of tax consequences (Code §736).

- Wages or guaranteed partnership payments to the younger generation may be used as deductions to lower the parents' self-employment income.
- Growing-in agreements may include non-cash wage compensation for the younger generation. Example: The owner's son or daughter receives half of the heifer calves as part of the wage paid. This is not subject to Social Security taxes but will reduce Social Security earnings for the parent employer.

There is great flexibility in the succession process if it is begun early enough. The options get progressively fewer as the parent approaches retirement. At age 65, it is no longer practical to use a growing-in agreement, partnership, or joint venture because normally none of these will get the parent removed enough from the operation to satisfy Social Security retirement rules. At this age, a sale or complete rental must often be used to totally shift management to the younger generation.

The incentive to move into management transitions earlier may be the dollars saved by shifting active income to passive. Potentially, thousands of dollars may be saved by the senior generation and, in most cases, the younger generation will not necessarily make up the difference. The exceptions would be the resulting profits from shared ownership, profits made on rented land, and guaranteed payments in a partnership. If the parent wants to remain involved in the business, he or she may do so, providing the regulations are met. After the first year, earnings rather than time spent are primarily used to determine involvement in the business. [But, watch for adverse consequences from some rental arrangements. See pages 7 and 8 of the Agricultural Issues chapter in this book.]

Another important reason to begin a transition to the younger generation several years before retiring is to avoid snags at the time of application for benefits. Social Security staff will be skeptical if one comes in at age 62 or 65 and says, "As of today, I am shifting from 100 percent ownership to begin retirement." If, on the other hand, the process begins several years prior to applying for benefits, the tax returns showing the parent's reduced involvement can be used as evidence of transition and, from experience, will usually be readily accepted.

The time to accomplish these transitions is from the older generation's late forties onward. With a farm, operating assets such as cattle, machinery, or feed are typically transferred first, with the farm remaining until last as the senior generation's retirement security. Gradual transitions are always more desirable from a tax-saving and management transfer standpoint.

Commonly Asked Questions about Benefits

To fill in any gaps in the preceding information, the following questions and answers will prove beneficial.

How much will my spouse receive if I die after we both retire?

Assuming both of you are full retirement age when you begin drawing, your surviving spouse will receive the higher PIA of the two. If your spouse has been drawing 50% of your benefits, he or she will then receive benefits double this amount, or two-thirds of your combined benefits.

What happens if my wife qualifies for her own benefit, but it is less than half of mine?

She will receive her own benefit plus the difference between that amount and half of yours, assuming full retirement age.

I have heard about college students receiving dependent's benefits. Are these available?

No. These benefits were available from 1971 to 1985, but have now been completely phased out.

I worked for the railroad for five years. How does this affect my Social Security?

A railroad worker does not qualify for railroad retirement benefits until he or she has worked 10 years. Any contributions you made to railroad retirement for those five years have been transferred to Social Security.

If I sell crop inventory from the previous year in the year I retire, will this reduce my benefits?

Yes, but there are special hold-over farm income exclusion rules that apply to certain crop and livestock income under certain conditions. Specifically, the excluded income must come from crops and livestock grown before retirement and sold the calendar year after the first year in which you draw benefits.

Any crop that you harvest and store in or before the first month of receiving Social Security benefits qualifies. All work involved in producing and storing the crop must be completed to be considered stored for the hold-over exclusion. Your involvement in marketing and the delivering of the crop to market do not count as part of the production and storage of the crop. Livestock sold and delivered from your possession in or before your first month on Social Security may qualify if the payment for the livestock is received in a year after the first year of Social Security benefits. By "first year" we mean calendar year. **Consider the following examples:**

Leo completes harvesting and storing his crops in November 1996. He reaches age 62 the same month and receives his first Social Security check in December 1996. If he sells crops valued at greater than $8,280 in December 1996, he will potentially have his benefits reduced $1 for every $2 over this limit—but only for December, because he only received one month of benefits in 1996. If he sells his crops in January 1997 (or any later month), the hold-over exclusion applies, and his benefits will not be reduced because the sale is in a year after his first year of receiving benefits. It does not matter that he retired in December. **Recall, however, that even though no benefits will be lost in 1997, the grain income will still be subject to self-employment taxes.**

Clara turns 62 in March 1997 and draws her first Social Security check in April 1997. She still has crop inventory of $100,000 from 1992 to 1996. If she sells the crops in April through December 1997, the hold-over exclusion will not apply. (It is her first year.) All of the net grain income will count toward the $8,640 limit in 1997 for those aged 62 to 65. If she continues to farm in 1997, her crops or livestock will not qualify for exclusion if produced after March. Any time these are sold, they will count toward earnings limits because they are produced after drawing her first Social Security check. However, if sold in 1998, the hold-over exclusion applies for inventory in storage as of April 1997.

Are there special rules for the first year of retirement?

There are special rules for the first year of retirement that allow a month-by-month earnings test for wage earners. Therefore, if you go over the wage limit in one month, you will only affect the benefits for that month. In 1997, the monthly limit on wages or earnings for those 65 to 69 will be $1,125, so for any month you exceed this amount, you will lose $1 of benefits for every $3 of excess wages. Those 62 to 64 will lose $1 for every $2 of wage income over $720 received in any month during their first year of benefits. Farm or business profits do not receive this month-by-month treatment, so beware of showing income over these levels any time during the year. The self-employed, however, have one other possible way of avoiding the repayment for the first year in which they receive benefits: the repayment is not required for months in which less than 45 hours of labor per month is performed. Also, in spite of the fact that certain farm or business income may be excluded from determinations on the loss of benefits, it is always subject to income and Social Security taxes.

What are the yearly amounts I can earn without losing some of my benefits?

The earnings limit for those under 65 is $8,640 in 1997, up from $8,280 in 1996. For those aged 65 to 69, these amounts are $13,500 and $12,500 for the same years. After age 70, there is no limit on earnings. Also, passive income such as interest, dividends, and gains from the sale of assets can be received in any amount without affecting benefits.

House Resolution 3136 (March, 1996) raised the earnings limits for those 65 to 69 sharply, increasing the limits as follows:

Figure 14 Earnings Allowed without Penalty for Those Age 65 to 70

Year	Annual Limit	Monthly Limit
1997	$13,500	$1,166.66
1998	14,500	1,250.00
1999	15,500	1,333.33
2000	17,000	1,416.66
2001	25,000	2,083.33
2002	30,000	2,500.00

Do I have to report my earnings to Social Security?

In some cases. Recent changes waive filing the earnings report for most Social Security recipients after January 1, 1997. In some instances, however, the report must still be filed. These occur where the tax return information does not accurately reflect the worker's situation. Instances might include the receipt of compensation earned earlier, deferred compensation reported on W-2s, hold-over grain, and receipt of government payments to name a few.

What happens if I have FICA wages and self-employment income in the same year?

Both types of earnings are subject to Social Security taxes, but their combined total cannot be more than the maximum creditable amount for the year ($65,400 for 1997, $62,700 for 1996). For example, if you earned $30,000 of FICA wages in 1996, only the first $32,700 of self-employment income would be subject to the old age, survivors, and disability portion of self-employment taxes. Medicare taxes are imposed on all Social Security income, regardless of magnitude.

Can I continue to receive quarters of coverage and earnings toward increased benefits after retirement?

Yes, any self-employment or FICA earnings, regardless of age, will be considered toward qualifying for or increasing benefits. Returns on the Social Security taxes payable for these earnings can be very favorable if the individual has had a lower-than-average earnings history. On the other hand, they may have no impact at all if the maximum computation years have been posted and each of those posted is greater than current earnings.

Can earnings before 1951 be used in calculating my benefits?

Yes, but in only a few instances: (1) if the worker has little or no earnings since 1951, or (2) if the worker has military duty after 1940, earnings before 1951 may be used to qualify for Social Security earnings credits of $160 per month, provided the military discharge was not dishonorable. Normally, only earnings received in 1951 or later are used to calculate benefits.

What is the controversy surrounding "notch-year babies"?

Notch-year babies were those individuals who turned 62 during the years 1979 to 1983. Thus, they were born from 1917 to 1921. What is significant about these individuals is that they became entitled to draw benefits during the transition period from the old benefit calculation method to the new method, which includes indexing. The law required notch-year babies to use the new method, which potentially resulted in almost $200 per month less than those born before 1917 with comparable earnings. In spite of vigorous lobbying by this group, any change in their benefits seems doubtful at this time, perhaps because retirees in this era were able to get back all of their tax paid plus interest in less than one year.

Is there a minimum benefit from Social Security?

No. At one time there was a minimum benefit, but there has not been one in effect since January 1, 1981.

My wife is on disability benefits. What happens when she reaches retirement age?

Her benefits will continue as before; she will not need to apply for retirement benefits. However, if she qualifies for higher dependent benefits on your earnings history, she can receive the difference added to her benefit when you retire.

What is the average benefit retirees will receive?

The average benefit in 1997 will be $745 a month, up from $720 in 1996.

What is the top benefit new retirees can receive?

For 1996 the top benefit for a single beneficiary was $1,248 a month. In 1997 this will rise to $1,326 a month. These apply to workers retiring at age 65 in January of 1996 and 1997.

Will I decrease my benefits if I do not pay in for a few years?

No, benefits are never reduced from what a worker is already entitled to. By not posting earnings for a few years, your benefits will simply not grow as they otherwise would have.

In contrast, disability benefits can be completely lost should you not post enough quarters on an ongoing basis to keep your currently insured status.

Is a disabled person able to have earnings without losing disability status?

Yes. The limit on earnings for a disabled person has been raised to $500 a month, up from $300 prior to 1990. This amount of earnings does not rule out having one's disability status reviewed, but it is an amount below which Social Security will not normally question the disabled person's status.

When should I apply for retirement benefits?

You should apply at your local Social Security office **no sooner than three months before you qualify for benefits.** You can receive your first check for the first full month you are 62 if you choose to retire early. Unless you are 65 or older, no retroactive benefits will be received. If you are past 65, up to six months of benefits can be received retroactive to your 65th birthday.

What information is needed when applying for benefits?

Retirement—Your Social Security number, birth certificate as proof of your age, and federal tax returns for the most recent two years.

Survivors or dependents—Your Social Security number and the deceased worker's number, proof of marriage for widow(er)'s benefits, children's birth certificates and Social Security numbers if they are applying for benefits, proof of support for dependent grandparents or grandchildren applying for benefits, proof of divorce if you are applying for benefits as a divorced widow(er) or former spouse. Other documents may be needed; the Social Security claims representative will inform the applicant.

What happens to a widow(er)'s benefits if she remarries after she begins drawing?

Unlike for a divorced individual, remarriage will have less effect on a widow(er)'s entitlement to benefits based on the deceased spouse's earnings. It does affect her if she is remarried before age 60, which removes her widow(er)'s eligibility.

How long must one be married before qualifying for widow(er)'s benefits?

One year in the case of death from natural causes; nine months in the case of accidental death.

In order for children to draw survivor's or disability benefits, must they be blood relatives of the worker?

No. As long as the worker provides a majority of the support for the children, they will qualify for benefits. Likewise, adoption is not necessary. If the children's natural parent divorces the stepparent receiving Social Security, dependent benefits for the stepchildren are terminated.

What happens when a divorced person receiving spousal benefits through his or her ex-spouse remarries?

His or her dependent benefits are lost based on the ex-spouse. This occurs regardless of when remarriage occurs, but any benefit privileges are restored should the individual become single again.

Is there a waiting period before a divorced person can draw benefits based on his or her former spouse's PIA?

No. Under prior rules, a waiting period of 24 months may have been required. Presently, if you were married to your ex-spouse more than two years, this waiting period is waived. If you were married less than two years, your ex-spouse must have applied for benefits, be covered by a worker's compensation offset, or be on a public disability on order for the waiting period to be waived.

I've heard the retirement age for Social Security is increasing. When does this occur?

The 1983 Social Security Amendment increases normal retirement age according to Figure 15. Many expect these provisions to be changed in the future, perhaps to a normal retirement age of 70.

Figure 15 Retirement Age for Full Benefits Based on Year of Birth

Year of Birth	Retirement Age to Collect Full Benefits
1938	65 years, 2 months
1939	65 years, 4 months
1940	65 years, 6 months
1941	65 years, 8 months
1942	65 years, 10 months
1943--1954	66 years, 0 months
1955	66 years, 2 months
1956	66 years, 4 months
1957	66 years, 6 months
1958	66 years, 8 months
1960 and later	67 years, 0 months

If I delay retiring until after my normal retirement age, will my benefit increase?

Yes, a delayed retirement credit will be given for each month after your full retirement age (seeFigure 15). The credit will be given according to Figure 16.

Figure 16 Delayed Retirement Credits

Year of Birth	Delayed Retirement Credit
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

1939--1940	7.0
1941--1942	7.5
1943 and later	8.0

Commonly Asked Questions about Strategy

I am considering renting out my farm next year. How will this affect my Social Security taxes?

This depends on the role you take as a landlord. Landlords who materially participate in the management of their property were made subject to self-employment taxes in 1956. The IRS has a precise definition of "material participation"; briefly, it means involvement in decision making, day-to-day management, work performed, or inspection of the farm on a regular basis. If a person does not materially participate, the income is considered rent and not subject to Social Security taxes.

Do my CRP payments qualify as self-employment income?

Again, this depends on whether material participation is taking place. If not, the payments can be treated as rent. For someone still engaged in farming other land, these payments are usually considered self-employment income. See the **Farmers Tax Guide** for more details.

Are ASCS payments for participation in government set-aside programs included in the earnings limit test if I am drawing benefits?

In most states, these are not included in the test because they are considered to be unearned; that is, not gained by active work involvement. There are some offices, however, that insist on including them in the test. Unfortunately, this is an area where total consistency between offices does not exist. These payments are taxable for self-employment tax purposes in any case, unless they stem from CRP participation where no work is performed and the farmer is no longer farming.

Is it good to generate higher Social Security income for several years before retirement?

The answer to this may vary, but normally the answer is no. An exception might be if the worker had very low earnings over his or her lifetime and had a spouse who would draw off his or her earnings history. Projected returns are normally low to moderate at this point, so inflating earnings is not a good idea.

Should I pay my spouse to build up his or her earnings base?

Normally the answer is no; however, a few exceptions exist. One would be if he or she wishes to qualify for retirement plan deductions or wants disability coverage. Further, one may need a wage to justify receiving fringe benefits, such as medical insurance. Another exception could be if he or she qualifies for his or her own benefit but has had relatively low earnings. The final exception would be for a spouse a few years older than the primary income earner. In the absence of these exceptions, shifting earnings will be the equivalent of throwing the funds away.

When would it pay to wait until age 65 to retire?

Again, a small minority of workers would fit this situation—only those who have very low lifetime earnings and need to build them up. In many situations, individuals wait to retire for personal reasons, but based purely on benefit returns, the vast majority should retire at age 62. Lack of health insurance continuation is the greatest barrier to early retirement for employees.

What is my normal life expectancy at age 65? Age 62?

For whites, the life expectancy at age 62 is 16.8 and 21.2 years for men and women, respectively. At age 65, this drops to 14.8 years for men and 18.7 years for women. These figures are compiled by the statistics section of Health and Human Resources in Washington.

How often should I check my earnings record?

Most authorities recommend checking your earnings every three years. There exists a limitation in making corrections of 3 years, 3 months, and 15 days after the year in which an error was made. There were, however, at least 10 exceptions to this rule, including errors on the employer's part, government errors, incorrect W-2s, and a host of others. Copies of tax returns, W-2s, and other evidence are needed to justify any changes; therefore, these documents should be kept indefinitely.

How often do errors occur on Social Security records?

I have seen errors quoted of 5 to 8% on workers' earnings records. The most common errors occur because of discrepancies in the Social Security number used. I have seen instances where taxpayers or their preparers used the wrong number or employers used with wrong number on W-2s. One taxpayer started using the wrong number in 1969 and had his earnings posted to another person's record for almost 20 years. It is estimated that more than $234 billion of earnings have not been properly credited to workers' earnings records.

What is the amount we should pay in to get the best return in benefits?

This is a difficult question to answer because, in most cases, there is not a specific dollar amount that is the magic figure to pay in.

Figure 17 Returns from Future SE Taxes: Based on Past Earnings and Marital Status

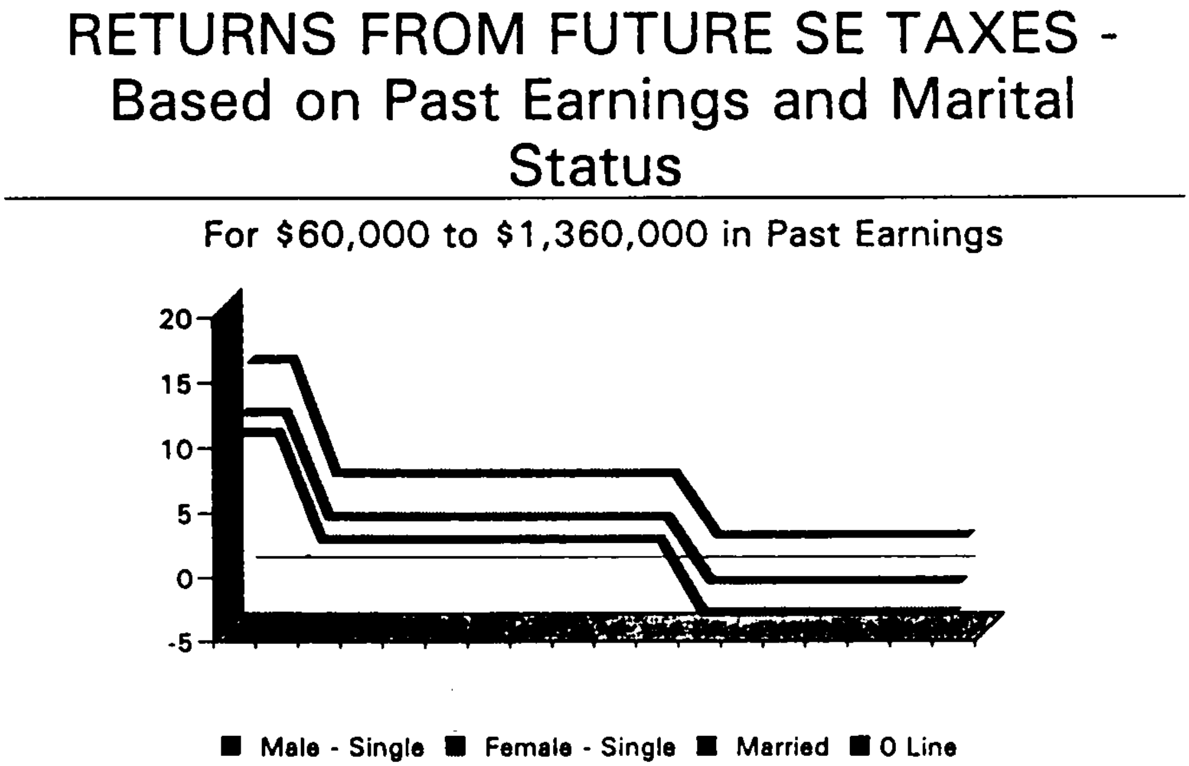


Figure 17 shows a short top step where the return on tax contributions is excellent. Only about one in 20 of those we have worked with have low enough earnings to still be in this bracket. The vast majority of farmers and small business people we have consulted with are in the broad middle step. This range of past earnings presently covers more than $3,000,000 over a person's lifetime. If a worker is in the middle of this earnings bracket, or step, the rate of return will be the same whether taxes are paid on another $20,000 or $200,000. Only if additional earnings push them into a lower step, or if they have accumulated enough earnings years to start eliminating lower years, will the return change. Often the answer for someone in their fifties goes something like this: "Your return for the next five years will be approximately 6%. After that the return will drop because each additional year of earnings will eliminate a lower one from the past." Now, whether that return will be slightly lower or significantly lower will depend on whether a $1,000 year or a $16,000 year is being eliminated. To sum up, in most cases, there is no magic number in earnings to contribute. The magic number to consider is the probable return from next year's tax contributions. If this return looks good, the contributions of any amount, up to the maximum, will probably give this return.

What is the rule with S-Corp distributions regarding inclusion in my income for the earnings limit test while I am drawing benefits?

These distributions are not self-employment or FICA income to the shareholder [Revenue Ruling 59-221, Reg. 1402 (a)-17(c)(2)], provided the IRS does not dispute the adequacy of the wage received by the shareholder. In some instances, local Social Security offices have taken the liberty of including these distributions in the earnings limit. Forming the S-Corp just prior to drawing benefits or lowering one's W-2 at a similar time may result in the inclusion of these amounts if the changes are deemed to lack purpose, other than to meet the earnings test.

Further Resources

The information shared in this chapter consists of excerpts from two books authored by Ronald D. Woltjer, EA. He is in his twelfth year as a Social Security specialist, both with the Farm Credit system and as owner of his own tax and consulting practice. The resources described here have been used by more than 5,000 legal, tax, and financial planning firms. Here are more details:

- Our **Social Security Analysis software** was born in 1986 to fill a void—comprehensive planning in the area of Social Security. It has been used to analyze thousands of clients, determine their best strategy in the areas of further contributions, disability, spouse's strategy, and early retirement, and avoid the elimination of prior earnings. It produces a six-page, client-ready report. Woltjer & Associates also uses the software to provide a national service bureau offering analysis services to the clients of other professionals. Purchasers of the Social Security Analysis software receive free phone support.

  $495.00

- **Managing Social Security,** 6th edition, is the most comprehensive book ever written on Social Security planning. It includes four chapters on Social Security basics, seven chapters on developing strategy, and six chapters on Social Security tax planning. The book was completely revised in 1997 and includes provisions of all four 1996 tax laws.

  $ 29.95

- Our **Managing Social Security** video is a full-day, live seminar presentation of our comprehensive Social Security seminar. Numerous charts, graphs, and computer inserts add to the valuable content.

  $39.95

- **Privatizing Social Security,** 1st edition, is a comprehensive vision of how to shift dollars saved by tax planning into IRS-sanctioned retirement programs. Three chapters on Social Security, five chapters on freeing tax revenue, and four chapters on retirement planning and pension plans round out this volume, new in 1997.

  $ 29.95

- The **Privatizing Social Security** video is a six-hour, live seminar filmed in May 1997. It uses the book of the same title as a seminar guide and looks at comprehensive efforts to shift Social Security and income taxes to privatized plans owned by the taxpayer. The book and video are sold together.

$ 59.00

- **Social Securities Strategies** is a newsletter designed to keep its subscribers up to date on current happenings and a variety of practical topics related to how the self-employed interact with Social Security. Legislative proposals are also examined as are individual scenarios from real life. The newsletter is published quarterly with several extra supplements included.

$69.00/year

- Our **Social Security Teaching Kit** includes handouts, a brochure, and over 60 masters for overhead transparencies. It also includes tips on how to successfully use the information to pull in new clients for these and other services. This new product was developed in 1996 and updated in 1997.

$75.00

- Our **§105 Medical Benefit Plan software** is designed to be a turn-key system for drafting a full set of documents needed to implement, administer, and defend a Code §105 plan. It maybe purchased alone or with Microsoft Works included. These products include free phone support. We also use this software to draft all the documents needed to establish and maintain a §105 Medical Benefit Plan for a one-time fee of $175.

$350.00; with MSWorks, $495.00

These tools are designed to take tax practice into the 21st century. They allow comprehensive planning and diversification into profit centers much in demand by those approaching retirement.

Any questions on these products and services may be addressed to Woltjer & Associates, 113 East Broadway, Little Falls, MN 56345 or call 888-SSA-1040. E-mail may be addressed to Woltjer@upstel.net. Interested parties may also access our web site at http://www.upstel.net~woltjer/home.html. Phone consultation is also available for client problems related to Social Security.