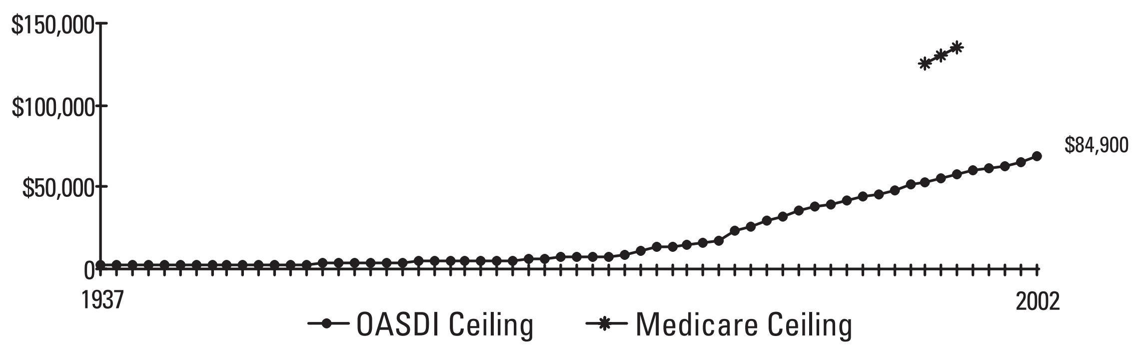
Chapter 10: Social Security

Corrections were made to this workbook through January of 2003. No subsequent modifications were made.

SOCIAL SECURITY PLANNING

For farmers and self-employed business owners, self-employment taxes have become the dominant tax. Since 1980, the potential self-employment tax contribution has more than quadrupled, reaching $11,996 for those paying at the Old Age, Survivor's, and Disability (OASDI) ceiling of $84,900 in 2002 (See Figure 10.1). The total for employees and employers combined is $12,990 (See Figure 10.2). When considering both halves of FICA, Social Security is the single largest tax liability for almost 80% of American taxpayers, and 70% of American families. Extensive new tax credits and adjustments directly from 2001 and 2002 legislation increase this trend, as virtually none of the adjustments directly affect Social Security. The graphs below show the dramatic increases in earnings ceilings and Social Security taxes since inception.

Figure 10.1
Social Security Earnings Ceilings for 1937 Through 2002*



*The elevated Medicare earnings ceiling from 1991 to 1993 has been eliminated and is now unlimited

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Figure 10.2
Maximum FICA and SE Taxes Payable for 1937 Through 2002*

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

In spite of this significance, Social Security remains a mystery to the vast majority of Americans. Many tax professionals also show a lack of expertise in this vital subject area. To alleviate this problem, this chapter focuses on the statutory formulas involved in calculating Social Security benefits, and then builds 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 or more. 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. The table below shows the quarters of coverage (also called credits) needed to be fully insured. "Currently insured" is a qualification used for disability and other non-retirement benefits and will be discussed later under disability benefits.

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/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 the table below). No partial credit is given for amounts over the amount specified. For example, in 2002, one must pay Social Security taxes on $870 to earn a credit, if one pays on $1739, only one credit will still be earned as the remainder over $870 will not earn the additional credit. Only one credit will be earned when the optimal method is used to compute self-employment tax.

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	1990	$520	$520
1978	250	250	1991	540	540
1979	260	260	1992	570	570
1980	290	290	1993	590	590
1981	310	310	1994	620	620
1982	340	340	1995	630	630
1983	370	370	1996	640	640
1984	390	390	1997	670	670
1985	410	410	1998	700	700
1986	440	440	1999	740	740
1987	460	460	2000	780	780
1988	470	470	2001	830	830
1989	500	500	2002	870	870

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

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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. Another 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 a divorce situation, remarriage will not affect the benefits of a widow(er) if he/she remarries after he/she is entitled to benefits (at age 60). A widow may also switch from his/her own benefit to a deceased spouse's without a carryover of any early retirement penalty from taking his/her benefits at age 62.

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/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 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. The table below shows the computation years for workers born in 1924 or later.

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 the following table).

The earnings listed 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 Personal Earnings and Benefits Statement (PEBES) is sent annually to every worker between age 24 and the time they draw benefits. It includes a year-by-year history of earnings since work began. One can also receive a printout of past earnings and benefits projections by submitting a written, phone, or web site request. Social Security's web site is www.ssa.gov.

Maximum Creditable Earnings

Year	Earnings Ceiling	Year	Earnings Ceiling
1937–1950	$ 3,000	1985	$39,600
1951–1954	3,600	1986	42,000
1955–1958	4,200	1987	43,800
1959–1965	4,800	1988	45,000
1966–1967	6,600	1989	48,000
1968–1971	7,800	1990	51,300
1972	9,000	1991	*53,400
1973	10,800	1992	*55,500
1974	13,200	1993	*57,600
1975	14,100	1994	**60,600
1976	15,300	1995	**61,200
1977	16,500	1996	**62,700
1978	17,700	1997	**65,400
1979	22,900	1998	**68,400
1980	25,900	1999	**72,600
1981	29,700	2000	**76,200
1982	32,400	2001	**80,400
1983	35,700	2002	**84,900
1984	37,800		

*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 $125,000, $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, this limit applies only to OASDI taxes.

Caution. The benefits quoted on the PEBES 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.)

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, 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. The following table shows the National Average Earnings since 1951.

National Average Earnings

Year	National Average Earnings	Year	National Average Earnings
1951	$2,799.16	1976	$ 9,226.48
1952	2,973.32	1977	9,779.44
1953	3,139.44	1978	10,556.03
1954	3,155.64	1979	11,479.46
1955	3,301.44	1980	12,513.46
1956	3,532.36	1981	13,773.10
1957	3,641.72	1982	14,531.34
1958	3,673.80	1983	15,239.24
1959	3,855.80	1984	16,135.07
1960	4,007.12	1985	16,822.51
1961	4,086.76	1986	17,321.82
1962	4,291.40	1987	18,426.51
1963	4,396.64	1988	19,334.04
1964	4,576.32	1989	20,099.55
1965	4,658.72	1990	21,027.98
1966	4,938.36	1991	21,811.60
1967	5,213.44	1992	22,934.42
1968	5,571.76	1993	23,132.67
1969	5,893.76	1994	23,753.53
1970	6,186.24	1995	24,705.66
1971	6,497.08	1996	25,913.90
1972	7,133.80	1997	27,426.00
1973	7,580.16	1998	28,861.44
1974	8,030.76	1999	30,469.84
1975	8,630.92	2000	32,154.82

The formula for indexing earnings is as follows:

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

Example 1. To illustrate the process of indexing, let's use the example of John Worker, who reaches age 65 and is considering retirement in 2002. John is married, and his spouse is age 64. 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 about making the correct decisions regarding retirement, questions that will be dealt with later in this chapter.

Let's assume John Worker has the earnings shown on the following table:

John Worker Earnings

Age	Year	Creditable Earnings	Indexed Earnings	Indexing Factor	Eliminated Years?
18	1955	$ 384.00	$ 3,190.00	8.30	YES
19	1956	3,583.00	27,819.18	7.76	
20	1957	1,484.00	11,176.09	7.53	YES
21	1958	2,247.00	16,774.52	7.46	YES
22	1959	3,623.00	25,770.11	7.11	YES
23	1960	4,200.00	28,746.13	6.84	
24	1961	4,200.00	28,185.95	6.71	
25	1962	4,200.00	26,841.87	6.39	
26	1963	4,800.00	29,942.14	6.24	
27	1964	4,800.00	28,766.52	5.99	
28	1965	4,800.00	28,257.72	5.89	
29	1966	4,800.00	26,657.59	5.55	
30	1967	4,800.00	25,251.04	5.26	YES
31	1968	4,800.00	23,627.15	4.92	YES
32	1969	4,800.00	22,336.30	4.65	YES
33	1970	6,600.00	29,260.36	4.43	
34	1971	6,600.00	27,860.45	4.22	
35	1972	7,800.00	29,987.22	3.84	
36	1973	7,800.00	28,221.41	3.61	
37	1974	7,491.00	25,582.66	3.42	YES
38	1975	7,407.00	23,536.82	3.18	YES
39	1976	8,063.00	23,967.52	2.97	YES
40	1977	10,800.00	30,288.11	2.80	
41	1978	13,200.00	34,295.39	2.60	
42	1979	14,100.00	33,686.83	2.39	
43	1980	15,300.00	33,533.32	2.19	
44	1981	16,500.00	32,856.00	1.99	
45	1982	17,700.00	33,406.43	1.89	
46	1983	19,654.00	35,371.23	1.80	
47	1984	23,240.00	39,502.79	1.70	
48	1985	24,453.00	40,012.84	1.64	
49	1986	16,488.00	26,105.80	1.58	NEXT
50	1987	29,382.00	43,732.14	1.49	
51	1988	31,258.00	44,340.55	1.42	
52	1989	31,818.00	43,415.92	1.36	
53	1990	37,199.00	48,517.25	1.30	
54	1991	39,188.00	49,275.16	1.26	
55	1992	42,001.00	50,224.47	1.20	
56	1993	42,282.00	50,129.37	1.19	
57	1994	44,129.00	50,951.67	1.15	
58	1995	38,564.00	42,810.28	1.11	
59	1996	39,547.00	41,854.60	1.06	
60	1997	22,145.00	22,145.00	1.00	YES
61	1998	23,650.00	23,650.00	1.00	YES
62	1999	48,523.00	48,523.00	1.00	
63	2000	51,205.00	51,205.00	1.00	
64	2001	52,369.00	52,369.00	1.00	
65	2002	56,000.00	56,000.00	1.00	
Totals		**$910,067.00**	**$1,599,961.00**		

From the column totals, one can see that the actual earnings are increased by about 75% by the indexing process. With current moderate inflation levels, indexing will be less significant for future retirees, especially those entering the workforce after 1985.

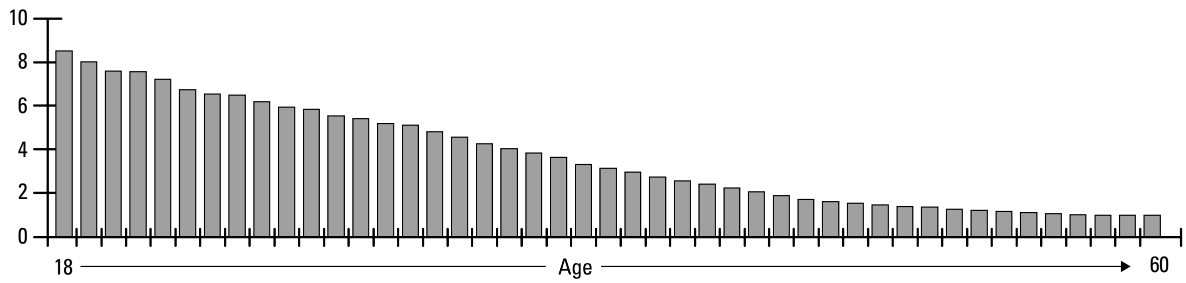
Example 2. Consider an example of how indexing works. From the table on the previous page, John had $7,800 credited to his earnings in 1972. In his indexing year (1997), the National Average Earnings were $27,426 and for 1972 they were $7,133.80 (see table on page 456). Applying the indexing formula,

$$\text{Indexed earnings for 1972} = \$7{,}800 \times \frac{\$27{,}426.00}{\$7{,}133.80} = \$29{,}987.22$$

In the same manner, the Social Security earnings need to be indexed for each of the worker's base years, except, 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 10.3 shows, a dollar earned at age 20 may be worth as much as seven or eight times the value of a dollar earned at age 60.**

FIGURE 10.3

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 that is two years prior to the year of 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 age 62 in 1999, will have been born in 1937 and have 35 computation years (see table on page 454).

Next, total the indexed earnings for the 35 highest computation years. Typically, this total will be approximately $100,000. For workers with very strong earnings histories, it will exceed $1 million. For John Worker, discarding the excess years leaves him with $1,326,848 of indexed earnings.

Divide the total indexed earnings by the number of months in the computation years. For **Example 2**, 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 $1,599,961 to $1,326,648. Dividing this figure by 420 months results in an AIME of $3,159. 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 $505 or less of AIME

- 32% of any AIME above $505 to $3,043
- 15% of any AIME above $3,043

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 1999.** (See the table below for current and past bend points.)

In **Example 2**, the $3,159 of AIME converts to a PIA of about $1,284.

$(505 \times .90) + [(3{,}043 - 505) \times 0.32] + [(3{,}159 - 3{,}043) \times 0.15]$

This is the starting point for calculating every type of Social Security benefit, except the $255 lump sum death benefit. If John waits until 65, he will actually receive $1406 per month, the extra $122 in benefits coming from three years of **COLA**s from age 62 to 65. If John retired early, his benefit would have been reduced by as much as 20%. He would only receive $1027 per month if he began drawing at 62. His benefit would increase by 6.5% for every year he defers retiring after age 65, up to a maximum of five years.

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/her spouse's PIA if he/she has no earnings history or if his/her earned benefit (PIA) is less than half of his/her spouse's.

Example 3. Using the same facts as **Example 2,** if John's wife also turns 65 in 2002 and begins receiving benefits, her benefit amount will be $703. It will be 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. If she draws her benefit at age 62, she will receive 37.5% of his PIA.

The bend points for converting AIME to PIA change every year. The thresholds used will be those from the following table:

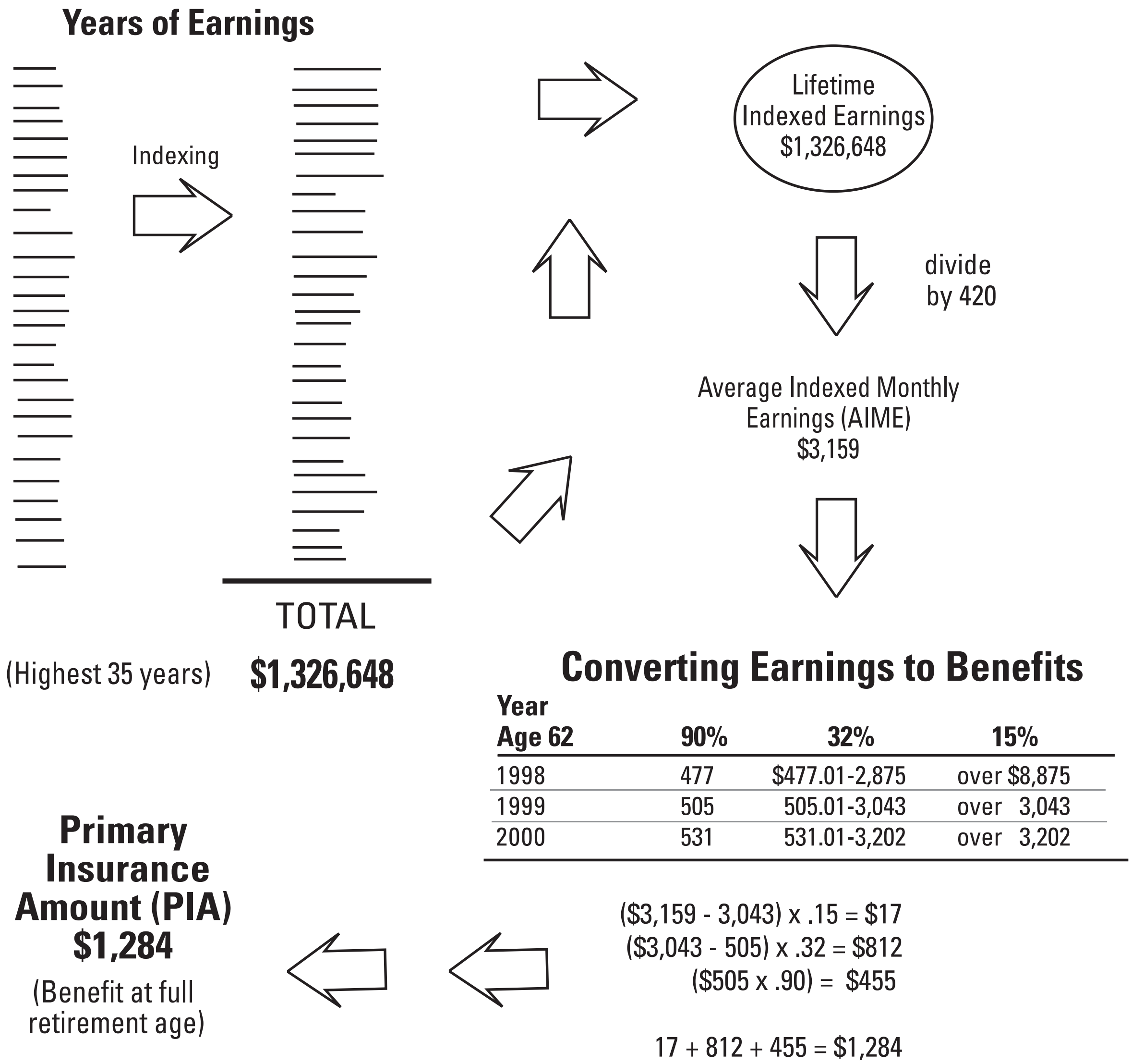
Bend Points for Converting Earnings to Benefits (AIME to PIA)

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
1998	477	477.01–2,875	over 2,875
1999	505	505.01–3,043	over 3,043
2000	531	531.01–3,202	over 3,202
2001	561	561.01–3,381	over 3,381
2002	592	592.01–3,567	over 3,567

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 at **www.ssa.gov.** The benefit calculation process is summarized in the following chart.

FIGURE 10.4

Computing a Social Security Benefit



Year Age 62	90%	32%	15%
1998	477	$477.01-2,875	over $8,875
1999	505	505.01-3,043	over 3,043
2000	531	531.01-3,202	over 3,202

The formula in Figure 10.4 is fairly straightforward. It is sometimes difficult to understand because of 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 which apply to us.

> **Note.** All variables in formulas are dependent on the worker's year of birth.

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

1. Indexing has a huge influence on the worker's ability to inflate benefits at any stage in his/her career. Just prior to retirement, it has a negative influence on attempts to increase benefits. It also makes a spouse with lower early earnings unlikely to ever overtake a spouse with strong, consistent, early and middle-age earnings. In **Example 2**, John's wife, with little or no earnings, would require almost $500,000 of Social Security earnings to match the spousal benefit to which she is already entitled. (This assumes she has no earnings now.)

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. At this point each new year forces the discarding of an earlier year, perhaps a very good one. In **Example 2**, John Worker has already discarded $273,113 of indexed earnings in the 12 eliminated years. The next posted year will discard $26,106 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. The **Example 2** worker is in the 15% conversion bracket, making further contributions a negative investment (about 4.4%, assuming a dependent spouse and normal life expectancies for both). If he were single, the probable return would be approximately 10%.

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 misconceptions concerning Social Security are listed below.

- **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 50-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 $439,637 of indexed earnings posted in the last decade only added $143 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 several $100 thousands of earnings 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.** The correct number of years is 35.

- **Social Security treats all of us the same.** Nothing could be further from the truth, and the disparity will grow. As Congress counts the cost of funding Social Security for the baby boom generation, those who are wealthier 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 list of the personal variables and the effect each has on 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 2% for each five years.
- **Gender — this affects life expectancy.** Women, on the average, receive an average of 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 less favorable.
- **The type of Social Security taxes to which the worker is subject.** 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 income shift will not be productive.

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 50s, 60s, and 70s. 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 present day, and received indexing for their pre-1979 earnings as much as 40% greater than their children will for the comparable life stage.

In its retirement Publication No. 05-10035, Social Security provides estimated benefits for individuals retiring at 10-year intervals over the next 20 years.

Approximate Monthly Benefits if You Retire at Full Retirement Age and Had Steady Lifetime Earnings

		Your Earnings in 2002				
Your Age in 2002	Your Family	$20,000	$30,000	$40,000	$50,000	$84,900 or More[1]
45	You	$ 876	$1,143	$1,409	$1,574	$1,977
	You and your spouse[2]	1,314	1,714	2,113	2,361	2,965
55	You	876	1,143	1,409	1,574	1,925
	You and your spouse[2]	1,314	1,714	2,113	2,361	2,887
65	You	820	1,072	1,323	1,453	1,660
	You and your spouse[2]	1,230	1,608	1,984	2,179	2,490

[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 may 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 full retirement benefit for the worker at normal retirement age (NRA), now 65.

The following table shows the percentage of PIA that may be received by various related individuals. Remember these amounts may also be limited by maximum family benefits.

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	70–80% 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 age 62	32.8–37.5% 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.** Some individuals qualify for benefits under more than one status. For example, a spouse may be insured for his/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

Disability Benefits are an overlooked and underrated area of Social Security. 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 that population.

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 do eventually qualify. Persistence can pay off.

> **Note.** Social Security disability benefits are the best buy in the insurance marketplace today. In 2002, as little as $532 a year in FICA or self-employment taxes 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 $3,480 in 2002.

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.

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 a person is disabled by blindness, the required credits may have been earned at any time after 1936. No recent credit is needed.

In Publication No. 0510029, Social Security 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 a person's age when disabled.

Before 24: Need six credits in the three-year period ending when disability starts.

24 through 31: Need credit for having worked half the time between age 21 and the time disability starts.

31 or older: Need the amount of credit shown in the table above, and generally must have earned at least 20 credits in the 10 years immediately before disability starts. Also needed are as many total work credits as would be needed for retirement.

- A young worker can qualify for disability benefits with as little as 18 months (six quarters) of earnings.
- In 2002, the average monthly benefit for a disabled worker was $794, while the average family benefit for the disabled worker and dependents was $1,325.

The following table shows the approximate monthly benefits a disabled worker with various earnings and family sizes would receive if disabled in 2002.

Approximate Monthly Benefits if You Become Disabled in 2002 and Had Steady Earnings

		Your Earnings in 2002				
Your Age in 2002	Your Family	$20,000	$30,000	$40,000	$50,000	$84,900 or More[1]
25	You	$ 876	$1,143	$1,409	$1,574	$1,921
	You, your spouse, and children[2]	1,314	1,714	2,114	2,361	2,882
35	You	876	1,143	1,409	1,574	1,921
	You, your spouse, and children[2]	1,314	1,714	2,114	2,361	2,882
45	You	876	1,143	1,409	1,574	1,921
	You, your spouse, and children[2]	1,314	1,714	2,114	2,361	2,882
55	You	876	1,143	1,409	1,574	1,921
	You, your spouse, and children[2]	1,314	1,714	2,114	2,361	2,882
64	You	839	1,095	1,351	1,487	1,689
	You, your spouse, and children[2]	1,259	1,643	2,027	2,231	2,547

[1] Earnings equal to or greater than the OASDI wage base from age 22 through 2002

[2] Equals the maximum family benefit.

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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.

Note. 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 4. 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 2001, she posted a profit and acquired four more credits, but still is four short of being currently insured.

Mary should be advised to amend her 1999 and 2000 returns to use the optional self-employment earnings method. In this way, she gains $1,478 of earnings and acquires one credit. Between 1985 and 1990, electing the optional self-employment earnings was only enough for Mary to earn three quarters. Between 1991 and 1998, the optional self-employment earnings provided two quarters and since 1999 it has only been enough for one quarter. 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 2002; 2003 would have been too late for amending a 1999 return if filing the amendment after April 15.

Example 5. In a more tragic example, Clarence, a bachelor farmer of 53, was diagnosed in 1993 with prostate cancer. With minimal earnings in the past 10 years, he had 17 credits out of the past 40 quarters. This is 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 of 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 this will provide 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 two prior years, and the election is limited to five times during the owner's lifetime. Farmers may use the optional method if gross farm income is $2,400 or less **or** net farm profits on Schedule F are less than $1,733. Using the optional self-employment method will only add one quarter 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.

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

SURVIVOR'S BENEFITS

According to the Social Security Administration, almost 20% of the 44 million people receiving Social Security checks get survivor's benefits. These include 5.5 million widows and close to three million children. In Publication No. 05-10084, an example shows the potential significance of such benefits.

Example 6. Consider a worker who died in 2000 at age 35, earned about $35,000 in 1999, and had an average earnings pattern before then. His survivors are his wife and two children, ages eight and ten. By the time the youngest child reaches 18, this family would receive $177,000 in Social Security benefits. This does not include any future cost-of-living increases. The following table gives approximate survivor's benefits under different situations.

Approximate Monthly Survivor's Benefits if the Worker Dies in 2002 and Had Steady Earnings

		Deceased Worker's Earnings in 2002				
Worker's Age in 2002	**Worker's Family**	**$20,000**	**$30,000**	**$40,000**	**$50,000**	**$84,900 or More[1]**
35	Spouse and one child[2]	$1,314	$1,714	$2,114	$2,361	$2,912
	Spouse and two children[3]	1,461	2,116	2,473	2,756	3,398
	One child only	657	857	1,057	1,180	1,456
	Spouse at age 60	626	817	1,008	1,125	1,388
45	Spouse and one child[2]	1,314	1,714	2,114	2,361	2,880
	Spouse and two children[3]	1,461	2,116	2,473	2,756	3,361
	One child only	657	857	1,057	1,180	1,440
	Spouse at age 60	626	817	1,008	1,125	1,373
55	Spouse and one child[2]	1,314	1,714	2,114	2,361	2,771
	Spouse and two children[3]	1,461	2,116	2,473	2,756	3,234
	One child only	657	857	1,057	1,180	1,385
	Spouse at age 60[4]	626	817	1,008	1,125	1,321

[1] Earnings equal to or greater than the OASDI wage base from age 22 through 2002.

[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 2002. Spouses turning 60 in the future would receive higher benefits.

> **Note.** The accuracy of these estimates depends on the pattern of 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.

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

- A strategy for further contributions; decide to 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:

1. To ensure a smooth transition into retirement; and
2. To exercise some control over Social Security tax contributions, potentially many thousands of dollars.

It is beneficial to examine each of the strategic elements listed above in more detail.

Example 7. Following Example 2 with John Worker, an additional year of earnings at $56,000 is added to John's history. What are 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 $7,913. Projecting these increases over our couple's lifetime and putting them into today's dollars, we find the following:

Retirement Age	Additional Lifetime Value of Benefits in Today's Dollars	Additional Costs in Today's Dollars*
62	$1,633	$7,913
65	$1,682	

*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: (4.59%)

Return on future Social Security tax at full retirement age: (4.42%)

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

Conclusions for John Worker

Returns. John's present Social Security tax contributions are showing a (4.4%) return, based on the assumptions mentioned earlier. He will have to compare this return with what he could get from other safe investment alternatives and adjust his Social Security earnings to reflect his decision. If John does reduce his Social Security contributions, his best strategy would be to invest the tax savings in pre-tax investments.

Years of Earnings. After the current year, John has paid Social Security taxes on 46 years of earnings. This is significant because he can use no more than 35 years of earnings in calculating his benefits, with each year beyond eliminating the lowest year in his earnings history. Presently, the lowest year not yet eliminated in his earnings history is $26,106. Any elimination will lower returns from future Social Security taxes.

Disability. One consideration to watch in this process is John's disability coverage. To maintain this, he needs to have Social Security coverage from 20 of the last 40 quarters prior to disability. John now has 40 out of the last 40. If he reduces his Social Security earnings, he will want to be sure to do so in a way that keeps this coverage intact. For 2002, John needs $3,480 of SE or FICA earnings to earn the four possible quarters.

Spouse's Benefits. John's spouse's benefits, based on her own earnings history, would be less than half of his, so her benefits will be based on John's earnings. His spouse would need future Social Security earnings of $446,381 to bring her benefit up to half of John's. This may not be a realistic option. Therefore, additional earnings on John's part will raise her benefits as well as his. Benefits quoted are for both.

Early Retirement. Analysis shows it would be a close decision financially for John to retire at age 62. By retiring at age 62, his benefits would be reduced by $379 per month, but the years of benefits up front would amount to $38,099.

The break even age for recovering this amount will be about 8.38 years. Consider that dollars received several years in the future won't be worth as much as dollars received sooner.

Retirement Qualifications. John will have to consider Social Security's requirement of reduced involvement for retirees when he makes his 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 $11,280 for those under 65 (2002) and $30,000 for those in their 65th year (2002), but in months before their birthday. These limits are increased each year.

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 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). 6% was used in **Example 7** on the previous page.
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/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 exception is infrequent because the 32% formula bracket is so broad — $3,904,688 of indexed earnings for a new retiree in 2002, increasing to almost $16,000,000 for someone in his/her twenties today. Therefore, one year of $10,000 future earnings may show the same return as ten years at $50,000 per year, especially for a person with low to moderate past earnings.

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

Returns. His present Social Security tax contributions are showing a (4.4%) return, based on the assumptions mentioned earlier. He will have to compare this return with what he could get from other safe investment alternatives and adjust his Social Security contributions to reflect his decision. If John reduces his Social Security contributions, his best strategy would be to invest the tax savings in pre-tax investments. Unfortunately, most pre-tax investments have limitations that are based on earned income. Hence, it is difficult to shift income into these investments.

The assumptions for John are as follows:

- Age 65, will be 66 in January
- Spouse age 64, will receive dependent benefits
- Social Security earnings began in 1955
- Normal life expectancies for both taxpayer and spouse
- 4.2% inflation, a 6% discount rate for future costs and returns
- Social Security taxes paid as self-employed

Obviously, the conclusion would be 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 (10%).
- If he were single and female, the return would be (6.6%).
- If their life expectancy is five years less, the return is (10.2%).
- If their life expectancy is five years more, the return is (1.2%).
- If we use a discount rate of 4%, the return is (4.3%).
- If we use an inflation rate of 3%, the return is (4.5%).
- If John were a true FICA employee, his return would be 0.8%.
- If John had less than 35 years of earnings, his return would be 0.5%.

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; and
- his current conversion bracket in the formula 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 drop to some degree if lower earnings years from the past are eliminated by new earnings years. It's advantageous to know how close the maximum years are, in order to set goals and establish a plan for the years remaining until retirement. Reporting alternative years of self-employment earnings is one potential solution.

For example, two years of $15,000 (Schedule C or F profits) could be lumped together as one year of $30,000. With farm income averaging or enough other income to apply to the standard or itemized deductions and exemptions, both scenarios may be taxed at a federal rate of 15%. More drastic moves to prevent elimination of past years may include selling the business, renting out business property, forming an entity, or early retirement. Income in the low year may also qualify the taxpayer for earned income or saver's credits, but may lower the refundable child credits. Examine the whole situation in these planning scenarios.

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).

With same facts for John Worker, he would be advised to do the following:

Years of Earnings. After the current year, John has paid Social Security taxes on 48 years of earnings. This is significant because he can use no more than 35 years of earnings in calculating his benefits. With each year beyond 35 years, he eliminates the lowest year in his earnings history. Presently, the lowest year not yet eliminated in his earnings history is $26,106. 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; he would be advised as follows:

Disability. One consideration to watch in this process is John's disability coverage. To maintain this, he needs to have Social Security coverage from 20 of the last 40 quarters prior to disability. He now has 40 out of the last 40. If he reduces his Social Security earnings, he will need to do so in a way that keeps this coverage intact. For 2002, he needs $3,480 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 a person's spouse strongly affects his/her personal strategy toward Social Security. Whether the spouse will draw benefits from his/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/her personal earnings history are less than half of the other spouse's, he/she will receive half of his/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 10 years. This trap is 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 his/her twenties when indexing is so pronounced.

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

- Has the couple been married 10 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 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:

Example 8. John and Mary are engaged in a business with $70,000 of annual profit. They are both 42. They have been married 11 years. 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, they are both still in the 90% conversion bracket, because they were both part of a religious order until age 31.

To calculate the break even 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, 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. Evaluate the probability of John acquiring the above amount of self-employment earnings in excess of Mary's self-employment earnings before retirement. Given their present earnings situation and no other influencing factor, this could be accomplished in less than three years by putting future earnings in John's name. This will allow Mary to draw as a dependent spouse. She should, however, be sure to post enough in wages to keep her disability coverage intact. Instituting a I.R.C. §105 Medical Benefit Plan for Mary would be an excellent option, making this decision even better.

There are several strategies for spouses of various ages, taking into considering the factors in **Example 8**.

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 50 than to do the same for an older spouse. Each situation should be evaluated for its results and merits.

For couples in their 50s, two more reasons for shifting earnings can arise:

1. If the prospects are great that a spouse will draw on his/her own history, 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.
2. If the lower-earning spouse is several years older than the higher-earning spouse, paying the lower-earning spouse a wage may allow him/her to draw on his/her own earnings history until the higher-earning spouse retires.

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 million 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 the profile described in the above "Note." The following advice should be given to them:

Spouse's Benefits. John's spouse's benefits, based on her own earnings history, would be less than half of his, so her benefits will be based on his earnings. She would need future Social Security earnings of $446,381 to bring her benefit up to half of John's. This does not appear to be a realistic option. Therefore, additional earnings on his part will raise her benefit as well.

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:

It is difficult to determine if the taxpayer is financially better off by retiring early. Consideration needs to be given to the time value of money and the worth of a dollar in the future.

The normal break even time needed to recoup the three years of benefits varies from 8 to 14 years. When the time value of money is added to the calculations, those who retire early may 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;
- worker would lose health coverage by terminating employment before Medicare eligibility;
- the high probability of paying back benefits by exceeding the earnings limit;
- the benefits becoming taxed at 50% or 85%; and
- the self-employed person is unwilling or unable to meet Social Security requirements for reduced work involvement.

The removal of the earnings limit for those past age 65 has altered this question somewhat for those making substantially more than the $11,280 (2002) now allowed at age 62. In many cases, having to decrease profits or wages $30,000 to $60,000 to qualify for benefits may require too great a sacrifice in standard of living to justify the decision. Unless other income sources are available, it may be best to wait until age 65 or the higher normal retirement age as time passes.

REDUCED INVOLVEMENT

The advice provided to John Worker highlights a common dilemma.

As discussed on page 469, when John retires, he is expected to reduce his involvement with his business. This includes both work and management activities. In addition he is limited in the earnings he can receive without a reduction in benefits.

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.

> **Note.** Earnings limitations for 2002 are $11,280 for ages 62 through 64 and $2,500 per month for those in their 65th year, but not yet having reached their birthday month. For those under age 65, benefits are reduced one dollar for each two dollars of earnings over the allowed limits. For those in their 65th year, 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 — $940 for ages 62 through 64 and $2,500 for those in their 65th year, but in months prior to the worker's birthday in 2002. Benefits for the self-employed, 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 age 65, the earnings limit is also prorated monthly for those months before the worker's 65th 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 65, 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 also rent assets from the parents without the involvement of an entity.
- Assets may be sold to the younger generation, resulting in principal and interest payments instead of profits.
- Special partnership rules may allow the senior partner to draw out his/her basis in a partnership free of tax consequences (I.R.C. §736).
- Wages or guaranteed partnership payments to the younger generation may be used as deductions to lower the parents' self-employment income. **Note:** The overall Social Security taxes are not changed, only shifted.
- 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 62, 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/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.

Another important reason to begin a transition to the younger generation several years before retiring is to avoid snags when applying for benefits. Social Security staff will be skeptical if one comes in at age 62 and says, "As of today, I am shifting from 100% 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, usually will be accepted.

The time to accomplish these transitions is beginning when the older generation is in their late forties and then onward. With a farm, operating assets such as cattle, machinery, or feed are typically transferred first, with the farm transferring last since it's 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

The following questions and answers will fill any gaps in the preceding information.

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/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/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 specific 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 delivering the crop to market does not count as part of 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:

> **Example 9.** Leo completes harvesting and storing his crops in November 1997. He reaches age 62 the same month and receives his first Social Security check in December 2001. If he sells crops valued at greater than $11,280 in December 2001, he will potentially have his benefits reduced $1 for every $2 over this limit-but only for December, because he only received 1 month of benefits in 2001. If he sells his crops in January 2002 (or any later month), the hold-over exclusion applies. 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 2002, the grain income will still be subject to self-employment taxes.

Example 10. Clara reaches age 62 in March 2002 and draws her first Social Security check in April, 2002. She still has crop inventory of $100,000 from 1998 to 2001. If she sells the crops in April through December, 2002, the hold-over exclusion will not apply. (It is her first year.) All of the net grain income will count toward the $11,280 limit in 2002 for those aged 62 through 64. If she continues to farm in 2002, 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 2003, the hold-over exclusion applies for inventory in storage as of April 2002.

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, only the benefits for that month will be affected. In 2002, the monthly limit on wages or earnings for those at age 65, but not having reached their birthday month, will be $2500. For any month that this amount is exceeded, $1 of benefits for every $3 of excess wages will be lost. Those aged 62 through 64 will lose $1 for every $2 of wage income over $940 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 age 65 is $11,280 in 2002, up from $10,680 in 2001. For those in their 65th year, but before their birthday month, these amounts are $30,000 and $25,000 for the same years. After age 65, 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.

Do I have to report my earnings to Social Security?

In some cases, you do. Rule 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 ($84,900 for 2002, $80,400 for 2001). For example, if you earned $30,000 of FICA wages in 2002, only the first $54,900 of self-employment income would be subject to time 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 only in certain instances:

1. If the worker has little or no earnings since 1951.
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 age 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 time 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 2002 will be $874 a month, up from $852 in 2001.

What is the top benefit new retirees can receive?

For 2001 the top benefit for a single beneficiary was $1,536 a month. In 2002 this rose to $1,660 a month. These apply to workers retiring at age 65 in January of 2001 and 2002.

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 maintain your 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 $780 a month, up from $740 in 2001. 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 age 62 if you choose to retire early. Unless you are age 65 or older, no retroactive benefits will be received. If you are past age 65, or the higher NRA for younger taxpayers, 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 in the month following the divorce.

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

His/her dependent benefits are lost based on the ex-spouse. This occurs regardless of when remarriage occurs. 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/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 in 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 the following table. Many expect these provisions to be changed in the future, perhaps to a normal retirement age of 70.

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. The delayed retirement credit shown below will be given for each year after your full retirement age, up to a maximum of five delayed retirement credits. The credit will be given according to the schedule below:

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
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?

If the rental is a cash arrangement, you should have no problem. If you rent your farm on a share rental arrangement and are actively involved, the IRS will take the position that the rent is subject to Social Security taxes. This issue was at stake in three appeals cases (*Hennen, Bot and McNamara v. Commissioner*, December 29, 2000), with all three rulings in favor of the taxpayers. In the first two, spouses were paid rent by their sole proprietor husbands, while the latter involved a couple receiving rent from their farm corporation for land owned outside the entity. The IRS attempted to tie active involvement in a cash rental situation with an obligation to pay Social Security taxes, but failed. These 8th circuit cases are not binding outside that district, but have obvious implications nation-wide. Litigation in this area seems to have slowed after these rulings.

Do my CRP payments qualify as self-employment income?

This issue was also the subject of recent litigation between the IRS and farmers taking the position that the payments were exempt from Social Security. In the widely cited case, *Wuebker v. Commissioner*, the IRS ultimately won in appeals on their position that, if a CRP recipient is still actively farming, the payments will be subject to self-employment taxes.

> **Note.** This ruling was made in the 6th circuit (Kentucky, Michigan, Ohio and Tennessee). Farmers outside these states have conflicting rulings, including the original Wuebker tax court ruling which ruled against the IRS. Again, we have some guidance from these rulings and appeals that would indicate a strong IRS position in favor of SE taxes on CRP payments for active farmers. If the farmer is no longer actively farming, the payments may be reported on Form 4835 without being liable for the Social Security taxes.

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, which insist on including them in the test. Unfortunately, this is an area where total consistency between offices does not exist.

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/her lifetime and had a spouse who would draw off his/her earnings history. Projected returns are normally low to moderate at this point, so inflating earnings is not a good idea. Only those with very low past earnings, a dependent spouse, FICA wages and great life expectancy should consider trying to increase their earnings just prior to retirement.

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

Normally the answer is no; however, a few exceptions exist. One exception would be if he/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/she qualifies for his/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 could 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. This applies to only those who have very low lifetime earnings and need to build them up, or those making too much to be able to meet the earnings limits for those younger than age 65. In many situations, individuals wait to retire for personal reasons, but based purely on benefit returns, many workers should retire at age 62. Lack of health insurance continuation is the greatest barrier to early retirement for employees. If your self-employment earnings are over the $11,280, and you wish to retain active ownership, it may be best to wait until age 65 to draw benefits. In this case, once you reach age 65, you can earn all you want in his/her business and still draw benefits.

Would it ever pay for me to wait until 70 to draw benefits?

In spite of the delayed retirement credit available for those who wait past their normal retirement age (now 65), it is extremely difficult to envision where waiting would be the proper strategy. A worker would be giving up an entire year of benefits to gain the credit. Even at very high incomes, only about one third of the benefits would be repaid in taxes (85% times a 40% tax rate).

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

For Caucasians, the life expectancy at age 62 is 18.0 years for men and 21.5 years for women. At age 65, this drops to 15.9 years for men and 19.2 years for women. Numbers for African-Americans, Hispanic-Americans and Asian-Americans are somewhat different. Figures are compiled by the statistics section of the Department of Health and Human Resources in Washington D.C.

Is there a time limit to correct my earnings record?

There exists a limit in making corrections of three years, three 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. The sole exception to the need for this documentation is in the case of a worker whose employer is the same before, during and after the year in question. Approximately 10 years ago, the Committee to Preserve Social Security won a court case that requires Social Security to accept the average of the wages earned before and after the missing year.

If returns are not filed for several years, will I still get credit for the Social Security earnings on my record?

No. Social Security will not waive the time limit for those who do not file their returns in a timely fashion. In one case, a business owner filed 10 years of returns, but was only given credit for the last three years.

How often do errors occur on Social Security records?

Quoted error rates are 5–8% on workers' earnings records. The most common errors occur because of discrepancies in the Social Security number used. There are 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.

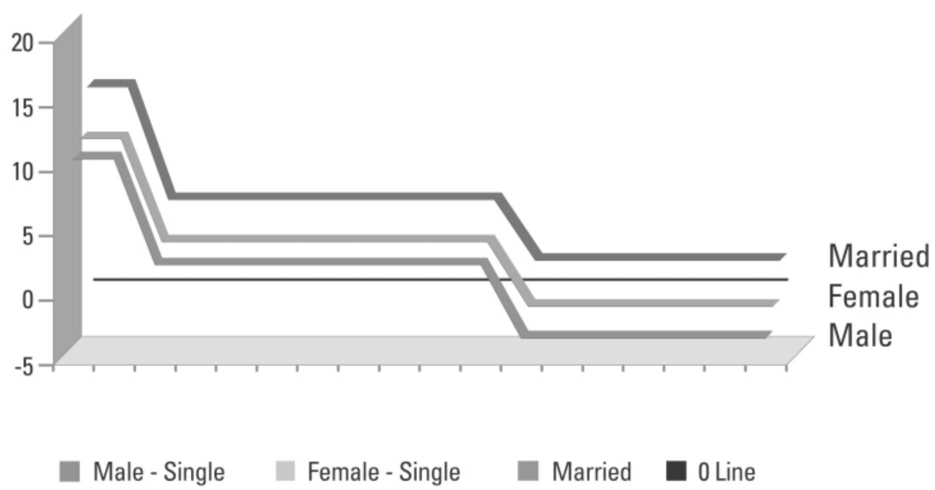
What is the amount we should pay in to get the best return in benefits?

This is a difficult question to answer because, in most cases, there is not a specific dollar amount.

FIGURE 10.4

Returns From Future SE Taxes (Based on Past Earnings and Marital Status)

For $60,000 to $1,360,000 in Past Earnings



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The graph on page 481 shows a short top step where the return on tax contributions is excellent. Only about one in 20 of those have low enough earnings to still be in this bracket. The vast majority of farmers and small business people 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 corporation 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 [Rev. Rul. 59-221, Reg. 1.1402 (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 corporation 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.

Isn't it impossible to control my Social Security contributions, even if they show a poor return?

Actually, many opportunities exist for self-employed farmers and business owners to manage their employment tax contributions. The four principle broad categories of tax moves that influence Social Security taxes include family moves, entity moves, using disparities in the way tax returns treat income, and fringe benefit moves. Each merits a brief discussion:

FAMILY TAX PLANNING AND SOCIAL SECURITY

A self-employed person has no greater asset than their family members. If they can render valuable service to the sole proprietor's business and receive compensation in the form of wages and fringe benefits, permanent tax savings will result.

Four principal avenues of tax-saving moves need to be explored in the area of family-related moves:

1. Involving one's spouse, either as employee, lessor, partner, or shareholder;
2. Directing fringe benefits to one's spouse as a condition of employment;
3. Employing one's children, especially those under age 18; and
4. Dividing income among family members through entity-related distributions or dividends.

A taxpayer must have a sound business reason to defend any of the above moves besides avoiding taxes. With good planning and structuring the business to use family employment effectively, these moves should be possible for many businesses. The tax savings can be very significant, perhaps enough to fund a parallel retirement program to Social Security.

ENTITIES AND SOCIAL SECURITY

The insertion of an additional entity into the tax management equation can introduce new abilities to manage income and self-employment taxes. This occurs because:

- Opportunities arise for business transactions between partners and shareholders and their respective entities.

- The Internal Revenue code allows for returns on equity, generally not subject to Social Security taxes, with entities. Rent received from an entity may represent such a return if the underlying property is free of debt payments or other expenses that would offset the rent. S corporation distributions to shareholders also represent returns on equity.
- In the case of a regular corporation, an additional tax-paying entity is created, with its own 15% bracket, and no self-employment taxes on profits retained for business capitalization or expansion.
- The ability of shareholder employees to receive fringe benefits tax-free from their corporate employers (C corporations only).

The decision to form an entity is not one to be taken lightly. Both tax and non-tax factors enter into the decision to choose a partnership, LLC, LLP, regular (C) corporation, or a subchapter S corporation. Partnerships are generally most similar to sole proprietorships. The dominant considerations in entity decisions are usually the fringe benefits, desire for flow-through distributions free from Social Security taxes, and the liability status of the business. Generally, a higher-income business with potential for abundant tax-free fringe benefits will choose a regular corporation, while a lower-income, mature business with dissolution potential will choose a subchapter S corporation. Each business owner considering incorporation needs to engage the services of expert legal and accounting professionals to aid in making that decision.

A final note regarding tax aspects of entities is that one loses certain tax options, as well as gaining some. Specifically, paying children under 18 without incurring FICA liability is a lost option when paid by an entity in place of a parent. Paying in farm commodities may negate this disadvantage.

Introducing an entity into the tax equation gives a significant degree of control over Social Security income and taxes. However, it is important to consider the broader implications of such a move-entities are not for everyone.

TAX FORM DYNAMICS: THE GREAT SHIFT

Income should be income, but it is not. Current tax law has significant inequities in the treatment of business income. The IRS code is infinitely complex and not always logical. Fortunately, the process sometimes works favorably, giving the taxpayer opportunities to characterize income in forms not subject to Social Security taxes.

As a rule of thumb, only those sources of income which are produced from wages or an active role in a business (earned income) are subject to Social Security taxes. Certain other types of income, such as director's fees and other miscellaneous actively earned income, are subject to Social Security taxes, but it is primarily net income or wages generated from an active, ongoing business that are subject to FICA or self-employment taxes.

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Several inequities exist in business income/deductions that are in favor of the taxpayer:

- Depreciable assets produce deductions on Schedule C or F, producing self-employment deductions. When later sold, the gain is reported on Form 4797, Part III. The best use of this move would be with vehicles eligible for I.R.C. §179. Two words of caution: First, business assets that are listed property with less than 50% business use are not eligible for I.R.C. §179; and second, any vehicles expensed must exceed 6000 pounds Gross Vehicle Weight Rating.
- Occasional income from work where the individual does not regularly carry on a trade or business is not subject to self-employment tax.

Example 11. Larry works in a bank but has carpentry skills from seasonal college jobs. His neighbor offers to pay him to help him build a deck on his house. If this is an isolated instance, Larry may report the income on line 21, Form 1040, and not pay self-employment tax on it.

- Net business income under $432 is not taxed for self-employment tax purposes. This amount, when multiplied by 92.35% on Schedule SE, falls just below the $400 threshold for filing the form and paying the self-employment tax. This is a substantial inequity with W-2 wage earners, since FICA is usually withheld from the first dollar.

- I.R.C. §1231 gains are not subject to Social Security tax unless the seller is in the real estate business, and the sales constitute his/her normal business activity.

On the negative side, several inequities exist that will work against a business owner attempting to minimize Social Security taxes. These include:

- Not including net operating losses in the computation of self-employment income. Even though they may arise entirely from prior years' Schedule C or F losses, they will not offset current profits. To be fair, the computations separating NOLs from one source compared with another source that may have arisen in another way could be quite complicated.
- Net I.R.C. §1231 losses on the sale of business property are not included in the computation of self-employment income.
- Business assets converted to personal use are subject to the recapture of Social Security taxes on the form on which they were originally deducted. This occurs through reporting the recapture on Form 4797, Part IV.

STRATEGIES FOR USING THESE INEQUITIES TO SAVE SELF-EMPLOYMENT TAXES

Making sure one considers the other tax and economic factors involved, here are potential strategies to consider:

1. Maximize depreciable basis by purchasing business assets straight out rather than trading in the old asset. Be sure depreciation on the new asset can offset recapture on the old one. The new special 30% depreciation allowance will aid in this offset.
2. Buy depreciable assets one year, sell them the next, pay the recapture, and then repeat the cycle. Examples: vehicles and computers.
3. Avoid net operating losses by leveling out business income from year to year; use reverse tax planning in potential loss years.
4. Farmers can use purchased breeding replacements rather than raised ones, depreciate or expense them, then pay the recapture.
5. In a low profit business, bring profits just under \$432 (\$432 $\times$ .9235 = \$400 on Schedule SE).
6. Avoid net I.R.C. §1231 losses by depreciating the assets (if depreciable) in question faster; this lowers the remaining basis upon sale, using the depreciation and switching the treatment of the gain to I.R.C. §1245.
7. Keep occasional employment from becoming a regular trade or business.

Obviously, these moves may not be possible or practical for certain industries or occupational situations. Within the ones that do fit, however, the ability to use them may generate thousands of dollars of tax savings annually, which may be diverted to retirement funds.

FRINGE BENEFITS: A GREAT TAX SAVER

Fringe benefits have become an increasingly important part of an employee's compensation package. For large companies, it is not uncommon to see benefits constituting 40% or more of an employee's compensation. Small businesses and farms are also becoming increasingly aware of their need to provide benefits if they are to attract and keep good employees. The purpose of this section is to provide information needed to understand the dynamics of fringe benefits as a tax-saving device, especially where the fringes are offered to family members or the owner in the role of shareholder/employee in a regular corporation.

A combination of increased competitiveness in attracting labor, gains made by organized labor, and government encouragement through favorable tax law has made benefits increasingly common.

Wages, Salaries, and Employee Benefits as a Percentage of Total Employee Compensation

		Employer Contributions to:				
Year	Wage & Salary	Social Insurance	Private Health Insurance	Pensions & Profit Sharing	Other	Total
1950	94.7	2.9	0.5	1.1	0.8	100.0
1960	91.9	4.2	1.1	1.7	1.0	100.0
1970	89.2	5.5	2.0	2.1	1.2	100.0
1980	83.8	7.8	3.6	3.3	1.5	100.0
1990	83.3	8.4	5.3	1.5	1.5	100.0
1991	82.9	8.6	5.5	1.4	1.5	100.0

Source: Calculations based on data from U. S. Bureau of Economic Analysis.

Note. Social insurance includes OASDI, HI, railroad retirement, government employee retirement, unemployment insurance, and public workers' compensation. The "Other" category consists mostly of life insurance and private workers' compensation.

Broadly defined, employee benefits may be any form of compensation other than direct wages paid to employees. The most typical categories of benefits include the employer's payment of:

- legally-required payments, such as FICA, FUTA, state unemployment taxes, and worker's compensation;
- retirement and savings plan payments;
- medical insurance and medically related benefit payments;
- life insurance and death benefits;
- payments for time not worked, such as sick pay, paid vacations, and holidays; and
- child-care and other miscellaneous benefits such as housing, meals, educational expenditures, etc.

TAX ASPECTS OF EMPLOYEE BENEFITS

Favorable tax legislation has had a tremendous impact on the expansion of employee benefits. The principal tax advantages of employee benefit plans are as follows:

- With few exceptions, the costs of employee benefits provided are deductible from the employer's current income as normal business expenses.
- These contributions, within prescribed limits, are not considered income to the employees.
- In most retirement and savings plans, the funds accumulate tax-free until distributed.

Congress continues to encourage the development of employee benefits. 1996 legislation conferred the same tax status to long-term nursing care insurance as has been enjoyed by medical insurance. 2001 legislation allowed the most significant expansion of retirement plans in more than two decades.

Employee fringe benefits also represent a way of conveying tax-free compensation to a spousal or other family employee. One must not discount the value of such benefits in attracting and retaining other employees as well. When offered, care must be taken to meet discrimination and administrative requirements.

CONCLUSION

Social Security taxes and benefits merit our attention as taxpayers and as professionals who serve the public as tax professionals. The tremendous growth of Social Security taxes following the 1983 Social Security amendment has resulted in the vast majority of Americans paying more Social Security taxes than any other. The magnitude of these tax contributions places the self-employed at the cutting edge of many tax controversies: commodity wages, S corporations, distributions, rent with active involvement, employee vs. independent contractor, just to name a few. This trend will continue, making quality education a must in this subject area. The importance of Social Security to an aging population base will also make a time investment in learning Social Security regulations a worthwhile move and potential practice builder. Social Security's importance can only grow as our population ages.