The Baby Boomer's Guide to Social Security

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What is Social Security?

Social Security was established in 1935 to alleviate poverty among the elderly during the Great Depression. It was created as a self-financing program that would collect payroll taxes from workers which would immediately be paid out in benefits to retirees.

Millions of Americans depend on Social Security. For many, it is their primary source of retirement income. For others, it is an important supplement to pensions and personal savings.

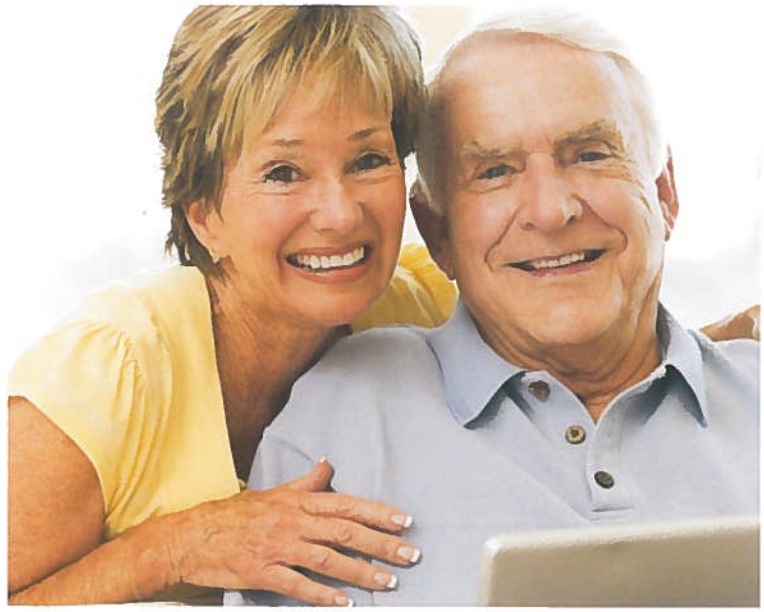
What are the benefits of Social Security?

Unlike other sources of retirement income, Social Security offers a unique combination of benefits.

- ✓ **A predetermined amount of income.** By the time you come to the end of a long working career, the amount of Social Security income you will be entitled to is pretty well known. The benefit is based on your earnings history as it is applied to a formula. While the amount may vary depending on when you apply for benefits (delaying benefits results in a larger amount), the relative accuracy of the estimate makes it easy to build the rest of your retirement income plan around it.
- ✓ **Steady income.** Once you have qualified for Social Security benefits, the amount of income you'll receive is set. Some people worry that benefits may be cut in the future, but it is highly unlikely that benefits paid to current retirees will be significantly affected by proposals to reform the Social Security system.
- ✓ **Lifetime income.** Social Security is one of the few sources of income that can be assured of never running out. Ida Mae Fuller, the first recipient of monthly Social Security benefits, continued to receive checks until her death at age 100.
- ✓ **Inflation-adjusted income.** Social Security benefits are usually increased each year based on the previous year's increase in the Consumer Price Index. These cost-of-living adjustments (COLAs) help retirees keep up with the rising cost of living.
- ✓ **Survivor benefits.** Although Social Security checks stop at death, benefits may be paid to surviving spouses and dependents.

How you become eligible for Social Security benefits

You become eligible for Social Security by working in a Social Security-covered job for at least 10 years. To be more precise, you need 40 credits. You can earn up to four credits in a year by earning a certain minimum dollar amount. If you earn four credits each year for 10 years, you accumulate the 40 credits necessary to be fully insured and achieve basic eligibility.



How your retirement benefit is calculated

To get an estimate of your Social Security benefit, go to **www.ssa.gov/myaccount**. Once you open an account you'll be able to view your earnings history and download your latest Social Security statement, which gives an estimate of your benefit.

The exact amount of your Social Security benefit is not computed until you turn 62. At that time, your annual earnings are indexed to account for wage inflation.

Once each year's earnings are indexed for inflation, your highest 35 years of earnings are tallied. If you worked more than 35 years, only the highest 35 years will count. If you worked less than 35 years, the missing years will count as zeroes. The 35 years of indexed earnings are totaled and divided by 420 (35 x 12 months) to arrive at your average indexed monthly earnings, or AIME.

Let's use Boomer Bob as an example. Born in 1960, Bob earned the Social Security maximum throughout his career. The maximum amount of wages subject to the Social Security tax is adjusted each year for inflation. When his earnings are indexed and averaged, his AIME comes out to be $11,430.

A three-part formula is applied to the AIME to arrive at your primary insurance amount, or PIA. Here is how the formula would apply to Boomer Bob:

- ✓ The first $1,024 of the AIME is multiplied by 90%.
- ✓ The amount between $1,024 and $6,172 ($5,148) is multiplied by 32%.
- ✓ The amount over $6,172 ($11,430 - $6,172 = $5,258 in this case) is multiplied by 15%.
- ✓ These are called "bend points," and they are adjusted slightly each year.

✓ The PIA for a maximum wage earner born in 1960 would be:

$1,024 x .90 =	$ 921.60
$5,148 x .32 =	$1,647.36
$5,258 x .15 =	$ 788.70
Total	$3,357.66

Bob's PIA is $3,357.60 This is the amount he will receive if he applies for benefits at age 67, his full retirement age.

When you may begin receiving Social Security benefits

If you apply for Social Security at your full retirement age (66 to 67 depending on your birth year), you will receive your full, unreduced PIA as your benefit. Early eligibility begins at age 62. If you apply at this age, your benefit will be permanently reduced. The age at which you apply for Social Security benefits has a tremendous impact on your monthly income and the total amount of benefits you stand to receive over your lifetime. This is one of the most crucial aspects of Social Security planning.

What if you apply at 62?

If you apply for Social Security when you first become eligible at 62, your benefit will be 70% to 75% of your PIA, depending on your birth year. If Boomer Bob, whose PIA is $3,357, applies at age 62, his monthly benefit will be 70% of his PIA, or $2,350. This is the amount he would receive for the rest of his life, increased only by annual COLAs.

The reduction for early benefits is called the actuarial reduction. It was calculated by actuaries based on average life expectancies. Whether people receive the lower amount starting at age 62, or the higher amount starting at full retirement age, the effect on the system is the same. However, the effect on you will depend on how long you actually live. If you take reduced benefits at 62, you will receive a lower monthly benefit for life. If you live longer than average, you will receive less in total benefits than if you'd waited until full retirement age or later to apply. You may also inadvertently cause your spouse's survivor benefit to be lower, in the event you pass away first.

What if you apply later?

Once you attain full retirement age, you can start receiving your full, unreduced primary insurance amount.

If you delay the onset of benefits past full retirement age, you will earn delayed credits. For each year you delay the start of benefits, your benefit will increase by 8% per year up to age 70, prorated monthly. If Boomer Bob waits until age 70 to apply, his benefit will be $4,163 (not including annual COLAs).

At the time of application, your delayed credits are calculated on a monthly basis. So you can apply anytime between full retirement age and age 70 and receive a prorated credit. Applying at age 70 earns you the most credit and results in the highest benefit.

How COLAs affect Social Security benefits

Each year in October, the Social Security Administration announces the amount by which monthly benefits will be increased starting the following January. This COLA is based on the year-over-year increase in the Consumer Price Index through the end of the third quarter.

COLAs are also applied to benefits that haven't been paid yet. If Boomer Bob waits until age 70 to start his benefit, it will increase by both annual delayed credits and COLAs. The estimate you see on your Social Security statement does not include COLAs; those estimates are in today's dollars.

How spousal benefits are calculated

A married person who has little or no earnings history can receive a spousal benefit equal to half the working spouse's PIA. Let's say Bill and Barbara are married. Barbara spent her time raising children and doing nonprofit work and therefore has no earnings record under Social Security. When Bill applies for his Social Security benefit, Barbara can apply for her spousal benefit. If Bill's PIA is $3,000, Barbara's spousal benefit will be half that, or $1,500, if she starts it at her full retirement age. If she starts it before her FRA (as early as age 62) her spousal benefit will be reduced.

If a spouse also qualifies for Social Security on her own work record, she will be paid that benefit first. To see if she is eligible for a spousal benefit, SSA will subtract her PIA from 50% of her husband's PIA. If the result is positive, she'll be paid this amount in addition to her own benefit to bring her total benefit up to 50% of her spouse's PIA. (Note: both amounts will be reduced if she applies before her FRA.) If her PIA is more than 50% of her spouse's PIA, she will not be eligible for a spousal benefit.

How divorce affects Social Security benefits

You can receive spousal benefits based on your ex-spouse's work record if the marriage lasted at least 10 years and you are currently unmarried. If you and your spouse have been divorced for at least two years, he does not need to apply for his benefit in order for you to receive yours. (He does need to be eligible for benefits and be at least 62.) You do not need to know his earnings history or even his whereabouts. All you have to do is present proof that you were married and divorced and give enough identifying information that the Social Security Administration can look up his records. It will then tell you what your benefit will be based on his record and help you proceed with the application. The benefit will be calculated the same as the regular spousal benefit shown in the prior paragraph. If your PIA is more than 50% of your ex-spouse's PIA, you will not be eligible for a divorced-spouse benefit.

How widowhood affects Social Security benefits

If you are both receiving Social Security when your spouse dies, the deceased spouse's benefit will stop. You can then switch over to your survivor benefit if it is higher. Your survivor benefit will equal 100% of your deceased spouse's benefit if you are over full retirement age when you claim it. There are three things to note about this.

One, your survivor benefit will be based on your deceased spouse's actual benefit, not his PIA. So if he maximizes his benefit by waiting until age 70 to apply, this would also maximize your survivor benefit. For this reason, the higher-earning spouse is usually encouraged to delay applying for benefits because this is the benefit that will prevail in the event of either spouse's death.

The second consideration is that one of the benefits will stop after the death of a spouse. If your spouse dies and you switch over to your survivor benefit, your own benefit will stop. If your own benefit is higher and that's the one you keep, your spouse's benefit will stop. Either way, you will need to plan for this loss of income, since most survivors need at least two-thirds of the income they were receiving as a couple. Life insurance or a cushion of other liquid assets can help fill this gap.

The third thing to know is that if you remarry after becoming widowed, you will not be eligible for a survivor benefit unless you are age 60 or older when you remarry (50 if disabled).

How working affects Social Security benefits

If you file for benefits before you turn full retirement age, and if you work, some of your benefits may be withheld. This is called the earnings test. One dollar will be withheld for every two dollars you earn over the annual threshold, which is adjusted for inflation each year. Because the earnings test is such an administrative hassle, it is recommended that you wait until you turn FRA or stop working to apply for benefits. If you apply for benefits starting the month you turn FRA or later, there will be no earnings test, regardless of how much you earned prior to application.

It is possible to improve your earnings record and increase your benefit by continuing to work. Everyone who works and pays into Social Security has their earnings record updated every year. If this results in a higher benefit – that is, in tabulating your highest 35 years of earnings the new year of higher earnings replaces an earlier year of lower earnings, your benefit may be adjusted upward. Lower earnings, such as by working part-time in retirement, will not cause your benefit to be reduced.

Please note that the estimate on your statement presumes continued earnings to claiming age. If you plan to stop working several years before claiming Social Security, your benefit will be lower than the amount shown on your statement.

How pension income affects Social Security benefits

If you receive a pension from a former employer, your Social Security benefits are not affected as long as you contributed to Social Security under that job. Other retirement income, such as distributions from 401(k) plans and IRAs, also do not affect Social Security. (Such income may affect the taxation of benefits, however; see next section.)

The only time pension income affects Social Security benefits is when you worked in a job that was not covered by Social Security. Under the Windfall Elimination Provision passed by Congress in 1983, retirees who are eligible for both Social Security and a generous pension from a job in which they did not contribute to the Social Security system may not receive their full Social Security benefit. The most common occurrence of this is when a person works for over 20 years in a civil-service job, then retires and works just long enough in a Social Security–covered job (10 years) to become eligible for Social Security benefits. (Or vice versa, the Social Security–covered job may have come first.)

A similar reduction may affect spousal benefits. If a spouse (not the worker) is eligible for a pension under a non–Social Security–covered job, the spousal benefit may be reduced under the Government Pension Offset. More information can be found on the Social Security website.

The important thing to note is that these benefit reductions under the Windfall Elimination Provision or the Government Pension Offset are not reflected in your Social Security estimate. This is because Social Security doesn't know if you are entitled to a pension until you apply for benefits and are asked to provide this information. Savvy Social Security planning would necessitate that you factor it into your benefit estimate now, rather than waiting to be surprised at the time of application.

How benefits are taxed

Your Social Security benefits may be taxable depending on how much other income you have. Here, we are not just talking about earned income but also income from pensions, investments, and even tax-free income from municipal bonds. If your modified adjusted gross income, plus one-half of your combined Social Security benefits, plus any tax-exempt interest you receive—called your combined income—is between $25,000 and $34,000 for those filing as an individual, or between $32,000 and $44,000 for those filing a joint return, up to 50% of your benefits may be taxed. If your combined income exceeds $44,000 if married filing jointly or $34,000 if single, up to 85% of your benefits will be taxed. If you are married filing separately, 85% of your benefits will be taxable no matter how much other income you have.

These threshold amounts were set in 1983 and are not adjusted for inflation. As Social Security benefits have increased and general income levels have risen over the years, more and more retirees are finding that their Social Security income is subject to taxation. The only way you can minimize this tax is to reduce your other income, which may require some belt-tightening as you strive to live on an annual income that puts you under one of the thresholds. Otherwise, you may have to accept the fact that part of your Social Security will be taxable.

The issue of taxation gathers complexity when you are coordinating Social Security with other sources of income. In fact, if you have other sources of income such as pensions or IRAs, it might be wise to delay taking Social Security benefits to age 70. This would allow you to earn delayed credits to boost your Social Security benefit and also defer taxation on those benefits. Consult with your tax advisor for guidance pertaining to your own situation.

How to apply for Social Security benefits

There are three ways to apply for Social Security:

- ✓ Online at **www.socialsecurity.gov**—for retirement, disability, and spousal benefits only (not survivor benefits)
- ✓ By phone at 800-772-1213 (TTY 800-325-0778)
- ✓ In person at a local Social Security office. Use the Social Security office locator at **www.ssa.gov** for the address, hours, and driving directions.

Information and documents you will need to provide

Have ready the following when you make your application:

- ✓ Social Security number
- ✓ Name at birth
- ✓ Date and place of birth
- ✓ Citizenship status
- ✓ The beginning and ending dates of each period of active-duty service, if service occurred before 1968
- ✓ Whether you receive, or expect to receive, a pension or annuity based on employment with the federal government or one of its state or local subdivisions
- ✓ Current marital status and spouse's name, date of birth, and Social Security number
- ✓ The names, dates of birth, and Social Security numbers (if known) of any former spouses
- ✓ The dates and places of each marriage and, for marriages that have ended, how and when they ended
- ✓ Names of any unmarried children under age 18
- ✓ The name and address of each employer for the last two years
- ✓ Information about self-employment
- ✓ Estimated earnings for last year and this year (and next year, if application is made between September and December)
- ✓ If you are within three months of turning 65, whether you want to enroll in Medicare Part B
- ✓ Bank account numbers for direct deposit

What about Medicare?

If you are receiving Social Security when you turn 65, you will be automatically enrolled in Medicare Parts A and B. You do not have to take Part B if you (or your spouse) are working and covered by an employer plan that covers 20 or more people.

If you are not receiving Social Security when you turn 65, you will have to proactively enroll in Medicare, either at age 65 or, if you have opted to stay on your employer group plan after age 65, when you stop working.

Once you start Social Security, Part A is mandatory. Even if you have opted to stay on your employer plan, if you apply for Social Security benefits, SSA will automatically enroll you in Part A, retroactive six months or back to age 65. Usually this is not a problem because Part A is free. But if you participate in a health savings account (HSA) at work, contributions to the HSA would have to stop. If you find yourself in this situation, talk to your employer about switching to a different type of health plan (or else opt out of the employer plan and go fully onto Medicare).