



SOCIAL SECURITY



4/26/17

How do the changes made to Social Security affect you?

As investment executives who specialize in helping our clients meet their financial goals, we understand that you may have questions about the areas you need to focus on during this phase in your life. This special report presents the changes Congress has made to Social Security, how these changes may affect you, and the various claiming strategies you can take advantage of to make sure you choose the best option to meet your financial goals.

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Retirement income planning has become an increasingly important topic for people as they contemplate their readiness to retire. Particularly with increasing life expectancies and the decrease of defined benefit pension plans, understanding where the ‘retirement paycheck’ is going to come from is more important than ever before. For those without an employer-provided pension, Social Security may represent the only retirement income source that is inflation-protected, guaranteed for life, and offers spousal coverage. This has made maximizing Social Security benefits critical for retirees. Even for retirees fortunate enough to have guaranteed pension income, it’s important to understand how Social Security benefits are affected by certain pensions and can be used in concert with pension income to achieve one’s desired retirement lifestyle.

This paper will discuss how you become eligible for benefits and how your Social Security benefits are calculated. We will also discuss how others can receive benefits based on a worker’s Social Security benefit, and how recent legislative changes have impacted benefit claiming strategies used by couples. Lastly, we’ll explore what to think about when deciding on when to claim your own benefits.

HIGHLIGHTS INCLUDE:

- Qualifying for Social Security Benefits
- Calculating your Benefit Amount
- Claiming Social Security Benefits
- New Social Security Rules as of 2016

1. QUALIFYING FOR SOCIAL SECURITY BENEFITS

To qualify for Social Security benefits, you must earn income that is reported to and taxed by the Social Security Administration.¹ As you work, you earn Social Security “credits,” and these credits are based on the amount of your wages and self-employment income throughout the year. You can earn up to a maximum of four credits per year and since a credit is earned for every \$1,300 of covered wages, you can earn four credits with earnings of \$5,200 in a given year. You do not have to accumulate one credit per quarter throughout the year, you may earn enough to acquire all four credits in one quarter.

Ultimately, you need 40 credits – earned over a minimum of 10 years – to qualify for Social Security retirement benefits. Credits do not need to be earned in consecutive years and any credits earned will stay on a person’s record. If you stop working for a period of time, then return to work, you can earn additional credits to add to your total.

2. CALCULATING YOUR BENEFIT AMOUNT

¹ Social Security limits the amount of wages that are subject to Social Security taxes each year. This limit, referred to as the Social Security wage base, is \$127,200 for 2017. A tax rate of 6.2% is paid on earnings up to the wage base by both the employee and employer, thus an individual with wages equal to or more than \$127,200 in 2017 would pay \$7,886.40 in Social Security taxes and their employer would pay the same. Self-employed individuals pay 12.4% Social Security tax on income up to the wage base. The wage base can increase each year.

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The actual amount of monthly benefit a person receives is based on a formula that begins by looking at an individual's lifetime of earnings. Actual earnings are adjusted for inflation to account for the changes in wages over time. Social Security uses the highest thirty-five years of inflation-adjusted earnings and applies a formula to arrive at your benefit amount, also called your Primary Insurance Amount (PIA). The PIA is the amount of monthly benefit you would receive at your Full Retirement Age, which is defined later. After your Primary Insurance Amount is calculated, the age at which you claim your benefit will determine your actual monthly benefit payment.

Note that the formula is always based on thirty-five years of earnings, therefore zeros will be used for years where there are no earnings. Older workers will often wonder whether it will help or hurt them to reduce their hours as they near retirement and earn less. The answer is that it can only help your Social Security benefit, but it will not reduce your benefit. This is because that year of reduced earnings later in your career will either bump out a lower earning year (inflation adjusted) earlier in your career, or it will not be part of your highest thirty-five years and thus not factored into your calculation.

3. FULL RETIREMENT AGE AND EFFECTS OF CLAIMING EARLIER OR LATER

Full Retirement Age (FRA) is 66 for those born between 1943 and 1954. The full retirement age increases by two months for each birth year from 1955 to 1960 at which time the FRA is age 67, as shown in the chart below. For example, somebody born in 1955 will turn 62 in 2017, and thus be eligible to claim a

benefit. Their FRA is age 66 and two months.

Your benefit will be reduced for claiming before your FRA and it will be increased if you claim later than your FRA. Let's first look at what happens when you claim early.

The earliest you can claim your Social Security benefit is age 62. Once you turn 62, Social Security

| Decreased Benefits for Claiming Early | | | |
|---|---------------------|--------------------------|-------------------------|
| Assumes a \$1,000 primary insurance amount (PIA) at full retirement age | | | |
| Birth Year | Full Retirement Age | Benefit Amount at age 62 | Percent Reduction at 62 |
| 1943-1954 | 66 | \$750 | 25.00% |
| 1955 | 66 and 2 months | \$741 | 25.83% |
| 1956 | 66 and 4 months | \$733 | 26.67% |
| 1957 | 66 and 6 months | \$725 | 27.50% |
| 1958 | 66 and 8 months | \$716 | 28.33% |
| 1959 | 66 and 10 months | \$708 | 29.17% |
| 1960 and later | 67 | \$700 | 30.00% |

Source: Social Security Administration

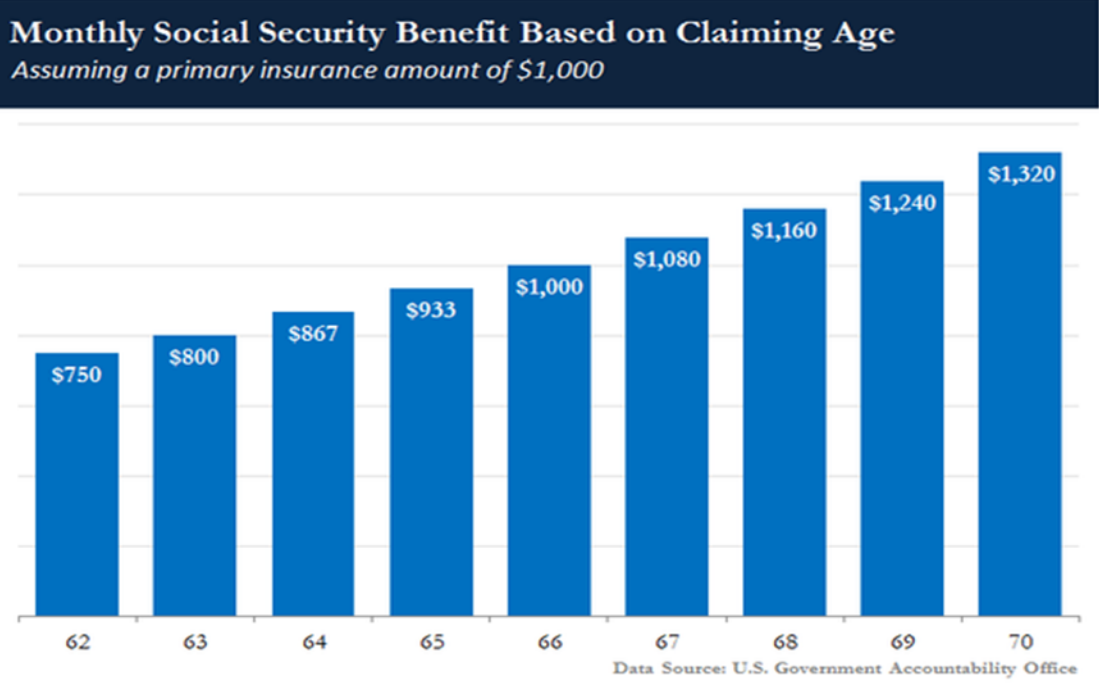
calculates your Primary Insurance Amount (PIA), which is the amount of monthly benefit you would receive at your Full Retirement Age (FRA). Even though they won't pay you your PIA at 62, it is calculated when you turn 62, so they know how much to reduce your benefit by if you start collecting at age 62. For example, as illustrated in the chart above, if you were born in 1954 and claimed your Social Security benefit in 2016 when you reached age 62, your benefit would be reduced by 25% for the rest of your life. If your full retirement age benefit would have been \$1,000/month at age 66, you would instead receive \$750/month at age 62.

For birth years between 1955 and 1960, the penalty for claiming at age 62 grows. If you were born in 1960 or later, your benefit will be reduced by 30% if you claim at age 62. Note that these reductions are permanent reductions in your benefit.

Conversely, if you claim your benefit after your FRA your monthly payment will increase. When you don't claim your benefit at your FRA, you start receiving Delayed Retirement Credits that increase your benefit by 8% per year up to age 70, at which time your benefit is maxed out and does not increase. Therefore, if your FRA is 66 and you wait to claim at age 70, your benefit will increase by 132% over those four years.

Social Security benefits are also eligible for Cost of Living Adjustments (COLA) annually. If you delay receiving your benefit after your FRA, you receive the Delayed Retirement Credit and any COLA increases if they apply for that year. For example, if you wait from age 67 to 68 and the government has declared a 2% COLA, your benefit will grow by 10% (8% Delayed Retirement Credit plus 2% COLA).

Deciding when to claim your benefit is an important decision since reductions for claiming early and additions for claiming later create a wide disparity between your potential benefit amounts. The chart below illustrates this. A person who would receive \$1,000/month at their FRA of age 66 would receive \$750/month at 62, or as much as \$1,320 at age 70. The age 70 benefit is 176% higher than the age 62 benefit.



SPOUSAL BENEFIT – BENEFITS FOR MARRIED COUPLES²

Social Security also pays benefits to spouses of workers that have qualified for their own benefit. The spousal benefit is based off of the worker's benefit, and can be paid to the spouse even if the spouse does not qualify for their own Social Security benefit. The spouse must be at least age 62 to claim the spousal benefit, and the other spouse must file for their own benefit in order to trigger the availability of the spousal benefit.

² Same-sex couples are now entitled to the same Social Security benefits as heterosexual couples. To qualify for spousal benefits, a couple must be married for at least one year and to qualify for survivor benefits, they must have been married for at least nine months.

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When claiming benefits as a spouse at their own full retirement age, they will receive 50% of the monthly benefit the other spouse would receive if their benefits started at full retirement age. If the spouse starts receiving benefits at:

- Age 62, they will get 35% of the monthly benefit instead of 50%.
- Age 65, they will get 45.8% of the monthly benefit instead of 50%.

For example, let's assume Alan has a full retirement age of 66 and would receive \$2,000 per month at his FRA. His spouse Mary also has a full retirement age of 66, and she does not qualify for her own Social Security benefit.

If Mary files for the spousal benefit at:

- Her age 66: she would receive \$1,000/month,
- Her age 62: she would receive \$700/month.

A spouse is also entitled to receive the spousal benefit even when they qualify for a benefit on their own working record. In this scenario, when a person is eligible for a spouse's benefit and their own benefit, they will only receive the higher of the two and the exact amount depends on their age when they claim.

By filing before their full retirement age, they are deemed to be filing for both benefits. In this case, a spouse cannot choose to receive either their own benefit or the spouse's benefit. Both retirement benefits and spousal benefits are permanently reduced when claimed prior to full retirement age.

Let's see how the numbers work. Using the example above, assuming that Alan is eligible for the same \$2,000/month benefit at his full retirement age, and that Mary is eligible for her own benefit of \$800 at her full retirement age. If Mary waits to claim a benefit at her age 66, Social Security will see that she is eligible for her own benefit and a spouse's benefit (remember that Alan would have to be claiming his own benefit to trigger the eligibility of the spousal benefit).

In this case, Mary would receive \$1,000/month because 50% of Alan's benefit is higher than her own. In this case, they are actually paying her own benefit of \$800 and topping it off with a \$200 spousal benefit to get her to \$1,000/month. If Mary's own benefit was higher than \$1,000/month, she would receive only her own benefit.

Now, what happens if Mary claims before her full retirement age? If she claims at 62, and Alan hasn't claimed his own benefit, then she will only receive her own benefit, which would be reduced by 25%, down to \$600/month. If Alan waits to his own full retirement age of 66 to claim his own benefit, now the spouse's benefit is available to Mary. Assuming she is also age 66 at that time, her benefit would increase by \$200, which is the full spousal benefit top-off amount discussed earlier. Note that this puts her combined benefit at \$800, not \$1,000 since she claimed her own benefit early, she is permanently reduced.

DIVORCED SPOUSES

In some cases, a person may be able to collect a benefit on their ex-spouse's record (even if the ex-spouse has remarried). To receive a benefit off your ex-spouse's record, your marriage must have lasted for at least 10 years and:

- You are not remarried;

- You are age 62 or older;
- Your ex-spouse is entitled to Social Security benefits, and
- Your own Social Security benefit is less than the benefit you would receive as an ex-spouse.

The benefit as a divorced spouse is equal to a maximum of 50% of the ex-spouse's full retirement age amount if collected at full retirement age. If claimed prior to full retirement age, the divorced spouse benefit is reduced in the same manner as the married spousal benefit discussed above.

Your ex-spouse does not have to be actually collecting their own benefit in order for you to collect a divorced spouse benefit, but they have to be old enough to qualify for benefits and you would have to have been divorced for at least two years. You cannot collect a benefit as an ex-spouse if you remarry. If your own benefit is higher than 50% of your ex-spouse's benefit, you will only receive your own benefit.

Note that a survivor benefit (discussed in detail below) is also available for a divorced surviving spouse provided that the marriage lasted for at least 10 years.

THE SURVIVOR BENEFIT

A Social Security survivor benefit is available to a surviving spouse at age 60, and that benefit is the greater of:

- The surviving spouse's own then-current benefit, or
- The deceased spouse's benefit at the time of their death.

If the deceased spouse's benefit is higher, and both spouses were currently receiving a benefit, the surviving spouse stops receiving their own benefit and instead receives the benefit of the deceased spouse. With the survivor benefit, no matter which spouse dies first, the smaller benefit drops off and the larger benefit is paid to the surviving spouse.

A survivor can receive up to 100% of the decedent's Social Security benefit (including Delayed Retirement Credits) if the survivor starts collecting this at their own full retirement age, or they can receive the survivor benefit as early as age 60 (or 50 if disabled). If a survivor benefit begins prior to full retirement age, the benefit is reduced. For example, claiming the survivor benefit at age 60 would mean that you would only collect 71.5% of the benefit the spouse was receiving when they passed away. To be eligible for the survivor benefit, a widow or widower must have been married to the deceased worker at the time of death, and for the nine months prior to death.

A key point to remember about the survivor benefit is that it can be claimed independently without impacting one's own benefit. Recall that if you claim the spousal benefit prior to full retirement age, and you also have your own benefit, you will automatically be paid the higher of the two benefits. This is not true of the survivor benefit.

For example, a surviving spouse can choose to receive their own reduced benefit at age 62, then switch to the survivor benefit at their full retirement age. If their own benefit is smaller, they can collect this first, then switch to the survivor benefit, and if they switch at their own full retirement age, they will receive 100% of what their spouse was receiving at the time of their death.

Alternatively, a widow/widower could claim only the survivor benefit at age 60 (benefit would be reduced by 28.5%) and let their own benefit grow. They could then claim their own benefit at any point between age 62 and 70. If they wait to their FRA, they could claim their full retirement benefit or wait to

age 70 and receive their maximum benefit that is 132% higher than their FRA benefit. Claiming the survivor benefit early would not have impacted their own benefit. This is a key difference between the survivor and spousal benefit.

4. NEW SOCIAL SECURITY RULES AS OF 2016

In November 2015, President Obama signed the Bipartisan Budget Act of 2015 into law. This Act contained legislation that went into effect in 2016 and changed two increasingly popular Social Security claiming strategies for married couples that were unintended loopholes within the system. These two strategies are known as the **File and Suspend** strategy and the **Restricted Application**. Let's first take a look at how the File and Suspend rules have changed.

File and Suspend refers to a method of claiming benefits which allows someone who has reached full retirement age (currently 66) to file for their own benefit then immediately suspend those benefits. The primary purpose of doing this under the old rules was to trigger the availability of the spousal benefit. Suspending their own benefit meant they would receive the 8% per year increases due to the Delayed Retirement Credits.

The Act provided a window of time in 2016 to be able to take advantage of the old rules, but after April 29, 2016, if a person suspends their benefit (must be FRA to do this), any benefits tied to that record (spousal, child, etc.) will also be suspended. Note that if the primary benefit owner begins receiving benefits again, the other suspended benefits will also resume.

Another feature within the File and Suspend rule that was impacted was the ability to request a lump sum. For those who were eligible to file and suspend by April 29, 2016, they preserve the right to request a lump sum payment of their benefits during the suspension period.

For example, let's assume that you filed and suspended benefits at age 66 to trigger the availability of spousal benefits while preserving the ability to continue earning with delayed retirement credits. If you decide two years later that you want to collect your benefits, you can either start your monthly benefit at that time and it will be 16% higher, since each year is worth an 8% increase, or you could request a lump sum payment of the two years of benefits that hadn't been paid during the suspended period. In the latter case, you would forfeit delayed retirement credits and receive a lump sum payment, and a monthly payment equivalent to what it would have been if you claimed at age 66.

The new law prohibits the lump sum payout option, so for anyone who files and suspends their benefit after April 30, 2016, they will not have the choice to receive a lump sum payment.

Under the current rules, there's really only one reason to file and suspend and that is to increase your own benefit if you had claimed early. For instance, if someone claimed their benefit at age 62 thereby receiving only 75% of their full retirement age benefit, they can still file and suspend when they reach their full retirement age. By suspending their benefit, they would stop receiving a monthly benefit, but would begin to accrue delayed retirement credits and for every year they wait, 8% will be added to their benefit payment. If they delay to age 70³, their benefit will have increased by 132%, which when

³ Delayed Retirement Credits only accrue up to age 70, so for practical purposes, there is no real benefit to delay claiming Social Security benefits beyond age 70.

added to their reduced benefit would get them to 99% of their full retirement age benefit ($75\% \times 1.32 = 99\%$)⁴.

The **Restricted Application** is another method of claiming that has been impacted by the 2016 legislation. Unlike the File & Suspend strategy which will still be available, but has lost its initial appeal with the new rules, the restricted application will eventually be completely phased out. Filing a restricted application allows a person who has reached their full retirement age to claim spousal benefits only. Note that for this to be available, the person's spouse must already be receiving their own benefit.

The primary reason to file a restricted application at full retirement age has been to collect a spousal benefit *ONLY* while letting your own benefit grow at 8% per year. It was a way to collect spousal benefits that otherwise would have gone uncollected, if two spouses only collect their own benefit, while simultaneously boosting your own benefit.

The new legislation provides the ability to file a restricted application only to those born prior to January 2, 1954, or in other words, people who turned 62 in 2015, (which includes a date of birth of January 1, 1954). Filing a restricted application is unavailable to anyone born January 2, 1954 or later.

Since you have to be full retirement age in order to file a restricted application, and people who turned 62 in 2015 are "grandfathered" in to be permitted to do this, the rule will be in effect for those people until January 1, 2020, when the youngest people in the grandfathered group reach their full retirement age of 66.

WORKING WHILE RECEIVING SOCIAL SECURITY BENEFITS

The earliest age to begin collecting benefits is 62. It is possible to collect benefits while you are still working, however, there are earnings limits in place that may result in a reduction of your benefits. If you are younger than full retirement age⁵ (currently age 66) and make more than the yearly earnings limit, your earnings may reduce your Social Security benefit amount.

If you are under full retirement age for the entire year, Social Security will deduct \$1 from your benefit payments for every \$2 you earn above the annual limit. The earnings limit for 2017 is \$16,920.

For example, let's say you are 62 years old and receiving Social Security benefits. Assuming you work and earn \$26,920 in 2017, which is \$10,000 over the earnings limit, \$5,000 will be deducted from your benefit (\$1 deduction for every \$2 over the limit). Let's also assume that your Social Security benefit is \$1,000/month. Social Security will withhold your first 5 months of benefits until they have withheld \$5,000, then they will resume your benefit payments for the remaining months of the year.

The rules change for the year you reach full retirement age. For the months of the year before you reach full retirement age, you can earn up to \$44,880 without having your benefits reduced. If you earn more than that prior to your full retirement age, \$1 in benefits is deducted for every \$3 you earn above \$44,880. Once you reach full retirement age the earnings cap does not apply and you can earn any amount without having your benefits reduced.

There is a special rule for people who retire midyear and have already earned more than the limit when they apply for Social Security. This rule applies to the first year of retirement and may enable you to

⁴ Source: Franklin, M., CFP. (2016). *Maximizing Social Security Retirement Benefits*. Retrieved April 26, 2017, from <https://home.investmentnews.com/clickshare/selectItems.do?CSCategory=maxSocSecBenefit>

⁵ See chart on page 2 for Full Retirement Age based on year of birth.

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receive a full Social Security payment for any month you earn below a certain amount. For 2017, if you are younger than full retirement age for the whole year, you are considered retired in any month that your earnings are \$1,410 (\$16,920/12).

This rule is illustrated in the following example provided by the Social Security Administration in their publication entitled, *How Work Affects Your Benefits*. For example, John Smith retires at age 62 on October 30, 2017. He will earn \$45,000 through October. He takes a part-time job beginning in November earning \$500 per month. Although his earnings for the year substantially exceed the 2017 annual limit (\$16,920), he will receive a Social Security payment for November and December. This is because his earnings in those months are \$1,410 or less, the monthly limit for people younger than full retirement age. If Mr. Smith earns more than \$1,410 in either November or December, he won't receive a benefit for that month. Beginning in 2018, only the annual limit will apply to him.

Note that Social Security benefits withheld prior to full retirement age due to exceeding the earnings cap are not lost forever. When you reach full retirement age, your benefits are recalculated and the percentage that your benefit is being reduced by is lowered. To illustrate how this works, let's assume you claim Social Security at age 62 and as you continue to work, you have had benefits withheld due to exceeding the earnings limits. When you reach full retirement age, Social Security will look at the total benefits that have been withheld. If you have had the equivalent of 12 months of benefits withheld, the Social Security Administration will recalculate your benefits as if you first claimed at 63, rather than 62. The net result is your 'penalty' for claiming early is reduced and your benefit will increase.⁶

SPECIAL RULES FOR PUBLIC EMPLOYEES

There are two Social Security rules that come into play for people who have had jobs where they did not pay Social Security taxes and they receive a pension from that work. These two rules are the *Windfall Elimination Provision* and the *Government Pension Offset*.

The **Windfall Elimination Provision (WEP)** applies in situations where a person qualifies for a public pension from a job where they did not pay into the Social Security system and they also qualify for a Social Security benefit from other work. If the provision applies, it only impacts a person's own retirement benefit, it does not impact the spousal or survivor benefit.

Although the WEP can reduce the amount of the Social Security benefit, it cannot eliminate it. In 2017, the maximum reduction imposed by the WEP is \$443 per month. Additionally, the reduction of the Social Security benefit is limited to 50% of the public pension; therefore, if someone was receiving a government pension of \$600 per month, their Social Security benefit would not be reduced by more than \$300 per month.

The **Government Pension Offset (GPO)** is another rule that can be applied when a person receives a pension from a job where they did not pay Social Security taxes. However, this provision only applies to reduce Social Security benefits for spouses, ex-spouses, and survivors. Unlike the WEP which can reduce, but not eliminate a Social Security benefit, the GPO can reduce a Social Security benefit to zero in some cases.

When the GPO is applied it reduces the Social Security benefit by two-thirds of the government pension. For an example, let's go back to our married couple, Alan and Mary. Let's assume Mary has been a

⁶ Source: Franklin, M., CFP. (2016). *Maximizing Social Security Retirement Benefits*. Retrieved April 26, 2017, from <https://home.investmentnews.com/clickshare/selectItems.do?CSCategory=maxSocSecBenefit>

school teacher for her career and is entitled to a pension of \$1,200 per month. Once Alan starts to receive his own Social Security benefit, Mary would be eligible to claim the spousal benefit. If her spousal benefit was equal to \$1,000 per month, it would be reduced by \$800 per month, since \$800 is two-thirds of her teacher's pension. She would therefore only receive a \$200 per month spousal benefit. If her Social Security spousal benefit was going to be \$800 or less, it would be completely eliminated by the GPO rule.

5. CONSIDERATIONS FOR SOCIAL SECURITY PLANNING

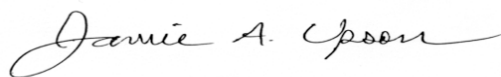
Navigating the world of Social Security rules can be tricky. Recent legislative changes have changed two popular claiming strategies for married couples, but there are still many different claiming scenarios available to help maximize your lifetime benefits. There is not a recommended claiming scenario that fits everyone's situation. Consideration should be given to one's entire financial plan and retirement goals when planning for Social Security benefits. Claiming benefits later can increase the amount you receive, however, it should be understood how this will impact your portfolio if you are using other assets to fund your retirement while waiting to collect Social Security. Testing various Social Security claiming scenarios within your actual financial plan to see how everything works together is the most recommended way to approach your retirement planning.

As always, if you have any questions, please lean on us here at Stonehearth Capital Management. We are here to help.

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