

## THE TRUTH ABOUT SOCIAL SECURITY

Social Security: a simple idea that's grown out of control. Social Security is the widely known "retirement safety net" for the American Workforce. When it began in 1935, it was intended as a supplemental benefit for a very small portion of Americans. Today, it's become the "primary" retirement income source for a majority of Americans. Along the way, a lot has changed. Let's take a look.

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### A long, long time ago... The origins of Social Security

The year was 1935. Franklin Delano Roosevelt was President of the United States. Life expectancy at that time was age 63. Social Security was designed to kick in at... age 65. See what I mean? This program was *originally* designed to benefit *very few* people. Not today. Today it's another story entirely.

Not more than a year ago, it was projected that Social Security would begin paying out, beginning in 2018 more than it took in. Sadly, we didn't even get close to 2018. It's happening already in 2011. As the Baby Boomers begin retiring in record numbers, Social Security will be paying out *more* than ever; at the same time, there are *fewer* people working and paying "Social Security Tax" to support all those benefits.

*"For OASDI (Social Security's Old-Age, Survivors, and Disability Insurance), annual cost will exceed tax income in 2010 by an estimated \$41 billion, although the combined trust funds will continue to grow because projected interest earnings of \$118 billion will substantially exceed \$41 billion. Annual cost is projected to exceed tax income by \$7 billion in 2011..."*

Source: [www.SSA.gov/oact/trsum/index.html](http://www.SSA.gov/oact/trsum/index.html),  
"A SUMMARY OF THE 2010 ANNUAL REPORTS;  
Social Security and Medicare Boards of Trustees"

The system is broken. It can't hold up very much longer. The question isn't, "Will benefits change?" The question is, "When and how much will it change for the American public?" For now, there's no real solution or answer, but if you're betting your retirement on Social Security, you might want to have a Plan B!

## How Much Do YOU Pay into Social Security?

If you work at a job and earn an income, you currently pay a 5.3% Social Security tax. Your employer also pays 5.3%. Combined, that's 10.6%. If you're self-employed, you get the pleasure of paying both employee AND employer contributions. In 2010, a total of \$686,000,000,000 (that's BILLION) was reported as "income" to the Social Security retirement fund, while expenditures were reported at \$586,000,000,000 (BILLION). On the surface that *looks like* there was more coming in than going out. But look under the hood and you'll find that "income" includes \$118,000,000,000 (BILLION) that was actually interest earnings. Take away the interest and you find that income from payroll taxes and taxes on Social Security benefits (more on that below) was actually only \$568,000,000,000 (BILLION) leaving a shortage of \$18,000,000,000 (BILLION). What's worse is the government is projecting bigger shortfalls from actual revenue in 2011 and 2012.

## What is YOUR total Contribution to Social Security Worth at age 67?

I thought you might be interested to know what you *might* be able to have in a retirement account of your own if your 5.3% plus your employer's 5.3% contributions were set aside in an account earning 5% compound interest over time. I realize you might have investments that earn *more - or less -* than 5%, but 5% is a fairly conservative long term rate of return. The chart below is based on \$10,000 of annual income. If you earn \$100,000, just multiply the results below times 10; if you earn \$44,000 per year, just multiply times 4.4 and so forth.

**Value of Total Contributions At Age 67  
Per \$10,000 of Annual Income**

| <u>Current Age</u> | <u>Projected Value at<br/>Your age 67</u> |
|--------------------|---|
| 20                 | \$188,796.68                              |
| 25                 | \$143,337.89                              |
| 30                 | \$107,719.75                              |
| 35                 | \$79,811.99                               |
| 40                 | \$57,945.54                               |
| 45                 | \$40,812.60                               |
| 50                 | \$27,388.50                               |
| 55                 | \$16,870.36                               |
| 60                 | \$8,629.12                                |

## Example

If you are 40 years old and single, earning \$50,000 per year, you could reasonably anticipate accumulating \$57,945.54 TIMES FIVE or about \$289,727.73. If you used that money to create an income guaranteed for life beginning at age 67 (your "FRA" or Full Retirement Age) with a guarantee that you could never run out of money (but without any increases for inflation) you would be able to have an income at age 67 of \$1,895.53 per month. (Source: Symetra Life Annuity quote, 02/17/11, male age 67)

If you wanted to at least partially account for inflation, you could use the same money to create a monthly income that would increase by 2% each year. Note that inflation has averaged 3% over long periods of time, so this increase isn't likely to keep your purchasing power up over time. With guaranteed annual increases in your income of 2% per year your *starting* monthly income would be \$1,600.01. (Source: Symetra Life Annuity quote, 02/17/11, male age 67)

Are these a good deal? If Social Security pays out what they project today, you might have an income of \$1,671 per month from Social Security with increases annually that are tied to CPI-U (Consumer Price Index – Urban).

## Inflation or No Inflation, That is The Question!

For the past two years, CPI-U has been "negative" or flat and, thus, there have been no increases in Social Security benefits. Also note that CPI doesn't include the cost of a lot of things you spend money on: things like gas for your car and food! How can that be? Frankly, I'm not sure. But let me ask you a question.

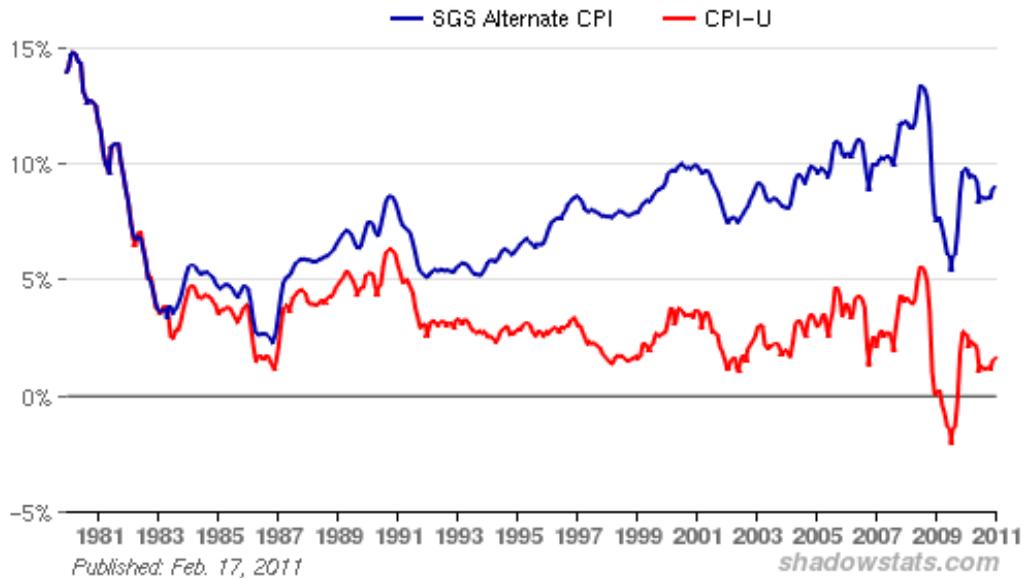
Suppose you were the largest employer in the world, and you were responsible for paying out hundreds of billions of dollars in annual pay. Suppose that you had told all of your employees you'd increase their income if there were an inflation. Now suppose YOU got to define what inflation was and that the rulebook said you could CHANGE the definition of inflation anytime you liked; the employees couldn't do a darn thing about it. Do you think you might work really hard to make sure the formula that determined "inflation" was set to make it seem as low as possible, so that you didn't have to keep increasing your payroll year after year after year?

Guess what?

That's exactly how it is with the federal government and inflation. The government gets to tinker with the formula and guess what? They DO! In 1981 they made big changes. They took out food and gas prices, but left housing prices in. That made inflation look a lot lower than what you and I experience when we go to the stores! If you look at what the "old formula" for inflation looked like, versus the current "adjusted" formula, you'll find a BIG difference. The chart below is courtesy of shadowstats.org and shows last year, instead of a PERHAPS 2% inflation rate, REAL inflation (or at least inflation the way the government USED to calculate it) was more like 9% year over year!

### Annual Consumer Inflation - CPI vs SGS Alternate

Year to Year Change. Through Jan. 2011. (BLS, SGS)



## When do Full Retirement Benefits Begin?

For now at least, “Full Retirement Age” (FRA) for new entrants into the Social Security system is age 67. It is gradually moving from age 65 to 67 based on the year you were born.

| Age To Receive Full Social Security Benefits |                     |
|--|---------------------|
| Year of Birth                                | Full Retirement Age |
| 1937 or earlier                              | 65                  |
| <a href="#">1938</a>                         | 65 and 2 months     |
| <a href="#">1939</a>                         | 65 and 4 months     |
| <a href="#">1940</a>                         | 65 and 6 months     |
| <a href="#">1941</a>                         | 65 and 8 months     |
| <a href="#">1942</a>                         | 65 and 10 months    |
| 1943–1954                                    | 66                  |
| <a href="#">1955</a>                         | 66 and 2 months     |
| <a href="#">1956</a>                         | 66 and 4 months     |
| <a href="#">1957</a>                         | 66 and 6 months     |
| <a href="#">1958</a>                         | 66 and 8 months     |
| <a href="#">1959</a>                         | 66 and 10 months    |
| 1960 and later                               | 67                  |

Source: [www.SSA.gov](http://www.SSA.gov)

## How Soon Can I begin To Receive “Early” Retirement Benefits?

While the age for full retirement benefits has been gradually moving to age 67, the age for early benefits remains age 62. You are able to receive “early” benefits when you turn 62, but your benefits will be significantly reduced for *life*.

According to the Social Security website:

*Here's how it works: If your full retirement age is 67, the reduction for starting your benefits at*

- *62 is about 30 percent;*
- *age 63 is about 25 percent;*
- *age 64 is about 20 percent;*
- *age 65 is about 13 and 1/3 percent; and*
- *age 66 is about 6 and 2/3 percent.*

*Source: ww.SSA.gov*

## When Should I Start Taking Social Security Benefits?

There's no “pat answer” to that. There are two schools of thought. One holds that you should always wait until at least full retirement age, if you are financially able to wait, because the increase from early retirement benefits to full benefits represents roughly an 8% “guaranteed increase” in your benefits for each year you wait. The other school of thought holds that you should always take your money as soon as it's available because, basically, a bird in the hand is worth two in the bush.

Bear in mind that according to the Social Security Administration, actuarially, the outcomes are the same. That's because the actuaries are looking at large groups of people and know they will average a certain life expectancy. But the actuaries do NOT look at individuals, and you are clearly a unique individual, so there could be an opportunity for you to do better by taking one option over the other. Let's look at each.

## The “Wait to Full Retirement Age” Rationale

Basically, this rationale assumes that you will live a long life. It holds the belief that by not taking benefits early and by waiting for a few years, you will receive a much higher monthly income for a long period

of time and, by waiting, your total income from Social Security will be more. If you have a good family history of long lifetimes, you *might* win using this strategy. If you are in very good health, you *should* win with this strategy. If the improvements in medical care and treatments continue to improve at the rapidly expanding rate they are today, you most likely *will* win by waiting before you take early benefits.

There are many calculators on the Internet that will help calculate the “break-even” age where you will have received more money than had you started early. Typically, it takes roughly 12 years or so. So, if you live to age 77 to 79 you should break even; live longer and you would be ahead of the game. Die sooner and you would have been on the short end of the stick.

## The Case For Taking Early Retirement Benefits

There are two main reasons not to wait. The first is your *health* and the second is your *need*. If you can't retire without Social Security income and you want or need to retire at age 62, then you might want to take early retirement even if you know that over the long haul you might have done better by waiting.

The other reason is your personal health or your family history. If you aren't in the best of health or your family has a history of dying on the young side, you might want to take your money as soon as possible. I have a friend who has a pretty serious case of diabetes. He has a life expectancy that is much less than the general population. In his case, I would probably suggest he start to take his retirement benefits as soon as he hits age 62.

## What if I Take Social Security Benefits and Still Work?

Sadly, between age 62 and *your* full retirement age, if you take Social Security benefits and have Wages (income from working, as opposed to income from interest or dividends etc.), your benefits will be reduced based on how much income you earn and how old you are. **There is no reduction in your Social Security benefits based on any wages you earn AFTER your full retirement age.**

How does the reduction in benefits work and how much income are you able to earn as of early 2011? This is spelled out very clearly on the Social Security website so rather than paraphrase it, I've copied it here for you to read right from the source.

## How earnings affect your benefits

You can continue to work and still get Social Security retirement benefits. Your earnings in (and after) the month you reach your full retirement age will not affect your Social Security benefits. However, your

benefits will be reduced if your earnings exceed certain limits for the months before you reach your full retirement age. (The full retirement age is 66 for people born in 1943-1954 and will gradually increase to 67 for people born in 1960 or later.)

- If you are younger than full retirement age, \$1 in benefits will be deducted for each \$2 in earnings you have above the annual limit (\$14,160 in 2011).
- In the year you reach your full retirement age, your benefits will be reduced \$1 for every \$3 you earn over a different limit (\$37,680 in 2011) until the month you reach full retirement age. Then you get your full Social Security benefit payments, no matter how much you earn.

If you are younger than full retirement age and some of your benefits are withheld because your earnings are more than \$14,160, there is some good news. When you reach full retirement age, your benefits will be increased to take into account those months in which you received no benefit or reduced benefits. Also, any wages you earn after signing up for Social Security may increase your overall average earnings, and your benefit probably will increase.

Source: [www.SSA.gov](http://www.SSA.gov) Are My Social Security Benefits Taxable?

## Are My Social Security Benefits Taxable?

In a word, maybe! One of my biggest pet peeves is the taxation of Social Security benefits. When Social Security began, FDR was asked at a press conference whether or not the benefits would be taxable. His answer? "Oh, no, no, no! These benefits will *never* be **taxed**." And do you think FDR kept his word? He did! He never allowed Congress to tax this "sacred cow," a staple of his "New Deal."

Unfortunately, in 1981, years after FDR had died, Congress decided to add a tax on a portion of the Social Security income that many Americans *receive*. They came up with a formula to determine how much money you make in retirement and call it "Provisional Income."

Provisional income is the sum of all of your income, ***including tax-free municipal bond interest***, PLUS one half of your Social Security income. If you are married and your Provisional Income is \$32,000, then half of your Social Security is *counted* as income and taxed. If you're single, the threshold is \$25,000.

## Income that counts towards the earnings limit test

What income counts toward the earnings test limit? For purposes of determining whether Social Security benefits are payable, a person's earnings for a taxable year are the sum of pay for services as

an employee plus all net earnings from self-employment (minus any net loss from self-employment) for that year.

Wages for Social Security purposes are gross wages: wages before any payroll deductions for income tax, Social Security tax, dues, insurance, or other deductions by the employer. We use gross wages as the basis for Social Security credit and for determining whether benefits must be withheld because of earnings.

Non-work sources of income, such as:

- inheritance payments
- pensions
- income from investments
- IRA distributions
- interest
- 401(k) distributions
- other sources;

In 1993, Congress decided taxing 50% of your Social Security just wasn't enough, so they added another threshold. If you are married and your Provisional Income is greater than \$44,000, then 85% of your Social Security is counted as income and taxed. If you're single, the threshold is \$34,000.

## **Is There Anything I Can Do To Reduce Or ELIMINATE the Tax On My Social Security?**

Funny you should ask! Yes, there very well may be.

There are two types of income you likely have in retirement. The first is income that you have control over, and the second is everything else, like pensions. Let's face it; you probably aren't going to call your pension people and tell them to "send less money," just so that your Social Security income isn't taxed. That wouldn't make sense. But-what about your interest, dividends, capital gains and even the interest you receive from what are supposed to be tax-free municipal bonds?

If you are receiving interest, dividends and capital gains income you are ***not*** using to live on, in other words income that stays in the account and is reinvested or allowed to compound, and you are not withdrawing it to use to live on, then you may be able to convert that income to a format that is not

counted against you, unless and until **you** decide to actually withdraw it from the account. As a result, you may be able to reduce or eliminate completely all the tax on your Social Security benefits. The best way to illustrate this is with an example.

### Example: Eliminating Tax on Social Security

Bob and Mary are age 70 and retired. Bob has a pension from his former company of \$1,000 per month or \$12,000 per year. Together, Bob and Mary also have \$500,000 in a portfolio of investments that are generating \$25,000 per year of interest from corporate bonds and from municipal bonds. Bob and Mary don't spend that money. They are living on Bob's pension plus their combined annual Social Security of \$22,500. Here's how we calculate their Provisional Income

|                       |          |
|-----------------------|----------|
| Wages...              | \$0      |
| Interest...           | \$25,000 |
| Pension...            | \$12,000 |
| 50% of SS...          | \$11,250 |
| Provisional Income... | \$48,250 |

Since their Provisional Income is greater than \$44,000, they MUST count 85% of their Social Security for income tax purposes. In their tax bracket that means 15% of their Social Security goes right back to the government. That's a cost of \$3,375 every year. While that might not seem like much, over ten years, if they had been able to hold onto that money and invest it at 5% it would be worth \$42,450. That could be enough to buy a new car every ten years or take a nice vacation every year!

## The Solution

Since Bob and Mary aren't using the income off their investments to live on, they could convert that portfolio to one where NONE OF THE INCOME is taxed or counted against them for Social Security tax purposes unless they decided to withdraw some of it. That puts THEM in much greater control. They now can decide when to make withdrawals and incur a tax bill.

For example, perhaps they only take a withdrawal once ever five or ten years, thereby, avoiding the tax on their Social Security for all the other years or they may never take money out of their investment account, but will just let it grow in case they need it in the future or leave to their kids.

As a result, while their money can still be earning the same 5%, it's now no longer counted in the Provisional Income formula. Here's how their new Provisional Income would look.

|                       |  |
|-----------------------|--|
| Wages...              | \$0  |
| Interest...           | \$0 (they still earn \$25,000 but it doesn't have to be counted here!) |
| Pension...            | \$12,000   |
| 50% of SS...          | \$11,250   |
| Provisional Income... | \$13,350   |

Since their Provisional Income is less than \$32,000, NONE of the Social Security is taxed. That's an ANNUAL SAVINGS of \$3,375 per year. That's NOT money that ever has to be paid back to the government; it's NOT tax deferral; that's actual TAX SAVINGS!

Unfortunately, not many people are aware that this is possible. Even fewer people realize that municipal bond interest is actually taxable when it comes to Social Security tax. And converting an account to tax deferred status is simple and easy.

## A Creative Social Security Planning Strategy for Married Couples

Many people who find themselves eligible for social security benefits believe they have little to no choice as to the payout options available to them. The common belief is the only choice you have is "WHEN" you should begin to draw on this income-earlier, or later. A much underused planning option is the "**File and Suspend**" payout option for married couples. Let's look at this example:

John and Mary are a married couple. John had larger income earnings over his lifetime and has reached full retirement age and is now eligible for maximum social security income. His wife Mary, also qualifies for social security income, but based on her lower income over her lifetime, her social security benefit is lower.

**Now, here is a planning option for them:** John does what is known as "**file and suspend.**" John, in fact, files for his benefit, and IMMEDIATELY suspends them. This can be done in the "remarks section" of the social security application.

Because John HAS filed for benefits, Mary can then choose her income option from the **HIGHER** of the 2 choices...the spousal benefit, or her regular benefit! Since John has suspended his payments, he can continue to work or draw income from his IRA, and then chose to receive his benefits at a later time, which may in fact INCREASE!

This is just one social security income planning technique;there are several others. But as with any financial planning, there are many variables to consider, so please make sure to consult with a professional income planning specialist before making any decisions.

## Conclusion

Social Security has gone from something designed to benefit just a lucky few who outlived their life expectancy to something that almost every American has come to expect as an entitlement. As a result, there's incredible financial stress on the system, and it may, frankly, run out of money unless some *major* changes are made to either *reduce* the benefits, *raise* the retirement age, *increase* the withholding taxes we all pay, or a combination of some or all of these. For now, it's here to help. How long it remains is anyone's guess.

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