Social Security and Your Retirement

Important information for investors' planning

Social Security will not — and was never designed to — provide all of the income you'll need to live comfortably during retirement. At best, your income from Social Security will supplement that from other sources.

To factor Social Security into your retirement plan, you should know how you can enhance your benefits and how much income you may need from other sources to be financially comfortable during retirement — especially if a portion of your benefits is subject to taxation.

How Social Security works

The basic concept of Social Security is that during their working years, all employees, employers, and self-employed individuals pay Social Security taxes, which are used to finance the program.

Employers and employees. In general, every employer and employee is subject to the Social Security tax. This tax really consists of two taxes: old age, survivor, and disability insurance (OASDI); and Medicare health insurance.*

Beginning Jan. 1, 2013, an additional Medicare tax of 0.9% is imposed on wages and compensation that exceed $200,000 for single individuals and $250,000 for married couples. This tax also applies to self-employed individuals.

The maximum annual wages subject to the tax differs dramatically for each of the two taxes. In 2017 the OASDI tax is imposed only on annual wages up to $127,200, whereas there is no limit on the wages subject to the Medicare tax. Therefore, if you are an employee earning $225,000, you will pay the following Social Security tax:†

6.2% on first:	$127,200	=	$7,886.40
1.45% on:	225,000	=	3,262.50
0.90% on:	25,000	=	225.00
Total Social Security tax			$11,373.90

Self-employed individuals. In 2017 the combined Social Security tax rate for self-employed individuals is 15.3% (12.4% OASDI and 2.9% Medicare) if below the threshold and 16.2% (12.4% OASDI, 3.8% Medicare) if above the threshold. Self-employed individuals can take an income tax deduction to partially offset the part of their Social Security tax burden that is normally borne by employers.

Social Security benefits

The OASDI program protects workers and their dependents from such financial losses as death and disability.

Retirement benefits. Your retirement benefit is based on your covered earnings during your 35 best working years and subject to automatic adjustments for cost-of-living

** For additional information about Medicare, ask your Financial Advisor for a complimentary copy of our Medicare report.*

† The employee tax is matched by the employer. The maximum OASDI wage base is subject to annual adjustments based on changes in wage levels. Congress may periodically adjust the tax rate. Check with your Financial Advisor for further updates.

increases. If you choose to start receiving your benefit at the age of 62, your benefit will be reduced. If you choose to receive your benefit starting at your full retirement age (see "Deciding When to Retire" on page 3), you will receive your full monthly benefits. (Full retirement age is also called "normal retirement age.")

Spouse's benefit. This benefit is available to a nonworking spouse if the working spouse is drawing Social Security benefits and the nonworking spouse applies for benefits:

Application	Benefit
1. At full retirement age	Full benefit*
2. At age 62 to full retirement age	Reduced benefit
3. While caring for an unmarried child younger than the age of 16 or disabled before the age of 22	Full benefit†

Child's benefit. This benefit is available to a retired or disabled worker's unmarried child. The child must be one of the following:

- Younger than age 18.
- Between ages 18 and 19 and a full-time secondary school student.
- Older than age 18 and disabled. The child's disability must have existed continuously since before age 22.

Survivors' benefits

Widow(er)'s benefit. The benefit depends on the widow(er)'s age when he or she applies for benefits:

Application	Benefit
1. At age 60 to full retirement age	Reduced benefit
2. At full retirement age	Full benefit‡
3. At age 50 to 60 and disabled	71.5% of full benefit
4. While caring for an unmarried child younger than the age of 16 or disabled before the age of 22	75% of full benefit†

Child's benefit. Available for each child who is younger than the age of 18, older than the age of 18 and who become disabled before the age of 22, or younger than the age of 19 and attending secondary school.†

Parent's benefit. Provides for a surviving parent aged 62 or older who was receiving more than half of his or her support from the deceased child.

Disability benefits

Qualified worker — totally disabled. Benefit available to worker younger than full retirement age who has been, or is expected to be, disabled for at least 12 months. After a waiting period of five months from the onset of the disability, benefits begin as if the worker had reached full retirement age. When eligible, the worker and his or her dependents receive benefits that would otherwise be payable at full retirement age.†

** Full benefit equals approximately 50% of the worker's retirement benefit. See "Deciding When to Retire" on page 3 for more information about full retirement age and reduction of benefits due to early distribution.*

† Subject to family maximum benefit.

‡ Full benefit equals approximately 100% of worker's retirement benefit.

Computing your benefits

Computing Social Security benefits is fairly complicated, and you should acquire specific numbers from your local Social Security office. Call the Social Security Administration at 1-800-772-1213 or visit ssa.gov.

Deciding when to retire

Full retirement age (i.e., age at which you can receive full Social Security benefits) is currently 66 (although it will increase gradually to 67 as shown in the table on page 4). However, you can begin receiving Social Security retirement benefits at a reduced rate as early as age 62.

In general, if you elect to take benefits before full retirement age, your monthly benefit will be reduced by five-ninths of 1% (1/180) for each of the first 36 months you receive benefits before full retirement age. A reduction of five-twelfths of 1% (1/240) applies for each additional month.

For example, assume you turn age 62 in 2017 and want to retire this year. Your local Social Security office has advised you that you will receive $1,000 per month if you start receiving benefits at age 66 plus two months (your full retirement age). Because you are retiring 50 months early, your benefit will be reduced by $258.33 [(36 x 1/180 x $1,000) + (14 x 1/240 x $1,000)] and your monthly benefit will be $741.67 ($1,000 - $258.33).*

As a rule, if you elect to take reduced retirement benefits before full retirement age, you will continue to receive a reduced benefit. If you wait until your full retirement age to begin receiving benefits, you will receive unreduced retirement benefits. It takes 12 years to make up the difference between receiving reduced benefits starting at age 62 and full benefits starting at age 66 plus two months. In other words, by the time you reach age 78, you will have received the same total number of dollars, regardless of when you started drawing benefits — at age 62 or 66 plus two months.

** This hypothetical example is designed to illustrate the effect of certain planning strategies based on stated assumptions. The strategy described may or may not be suitable for your particular situation. Before implementing any strategy, consult your tax and legal advisors. No guarantee of specific results is made; past performance is no guarantee of future results.*

The following table shows how full retirement age gradually increases based on your birth year.

Birth year	Full-retirement age	Age 62 reduction
1937 or before	65 years	20.0%
1938	65 years + 2 months	20.8
1939	65 years + 4 months	21.7
1940	65 years + 6 months	22.5
1941	65 years + 8 months	23.3
1942	65 years + 10 months	24.2
1943 to 1954	66 years	25.0
1955	66 years + 2 months	25.8
1956	66 years + 4 months	26.7
1957	66 years + 6 months	27.5
1958	66 years + 8 months	28.3
1959	66 years + 10 months	29.2
1960 or later	67 years	30.0

Source: Social Security Administration, 2017

The following table indicates early retirement's effect on Social Security benefits if your full retirement age is 66.

Age when benefits begin	Percentage of worker's benefit at age 66
62	75%
63	80
64	87
65	93
66	100

Will your earnings pass the retirement test?

You may have to stop working or give up some of your earned income to receive Social Security retirement benefits. If you are younger than full retirement age, you must meet certain requirements outlined in the Social Security Administration's retirement earnings test to receive your full benefits.

In 2017, a worker between the age of 62 and his or her full retirement age can earn no more than $16,920 without affecting his or her Social Security benefit. Social Security will deduct $1 from benefits for every $2 earned in excess of $16,920. These earnings include wages, self-employment income, bonuses, commissions and fees. This limit is indexed for inflation.

However, in the first year you retire, the Social Security Administration will let you limit the deduction from your benefits. Here's how: If your earnings exceed the earnings limit but you receive those earnings in only a few months of the year, you can receive a monthly benefit for each of the months in which your earnings were not more than one-twelfth of the annual earnings limits and no substantial services in self-employment were performed.

You should note that in the month in which you reach full retirement age and every month thereafter, Social Security will not deduct any of your benefits, even if you are still working and regardless of what you earn.

Taxation of Social Security benefits

Taxation can dramatically affect your Social Security benefits. As much as 85% of your benefits may be subject to income tax. Taxation of your benefits depends on your "provisional income," which is your adjusted gross income (AGI) plus nontaxable interest income plus one-half of your Social Security benefits.

Once you've arrived at your provisional income, you must compare it with predetermined thresholds to determine your benefits' exposure to taxation, as shown in the table below.

	0% to 50% taxed	50% to 85% taxed
Married/joint	$32,000 – $44,000	Over $44,000
Single	$25,000 – $34,000	Over $34,000

How to calculate the taxable portion of your benefits

A two-tiered formula, as shown in the following example, applies for calculating the taxable portion of your benefits.* Let's assume you and your spouse have income from a pension, municipal bonds and Social Security and you file a joint tax return.

Step 1: Compute your provisional income

Again, your provisional income is your AGI plus nontaxable interest income plus half of your Social Security benefits. Here is the calculation for our example:

	Total income	Provisional income
Pension income	$15,000	$15,000
Municipal bond interest	25,000	25,000
Social Security benefits	14,000	7,000
Total income	$54,000	————
Provisional income	————	$47,000

Step 2: First-tier calculation — 50% threshold

The first tier of the formula applies to provisional income of more than $32,000 but less than $44,000 (between $25,000 and $34,000 for unmarried individuals).

Because your provisional income exceeds the $32,000 threshold, you must first calculate the portion of your benefits subject to the 50% taxation tier.

* *This hypothetical example is designed to illustrate the effect of certain planning strategies based on stated assumptions. The strategy described may or may not be suitable for your particular situation. Before implementing any strategy, consult your tax and legal advisors. No guarantee of specific results is made; past performance is no guarantee of future results.*

Provisional income	$47,000
Less 50% taxation threshold	(32,000)
Excess of provisional income over 50% threshold	$15,000

For the first-tier calculation, the taxable portion of your benefits is the lesser of:

50% of the excess *($15,000 x 50%)*	$7,500
– or –	
50% of Social Security benefits *($14,000 x 50%)*	7,000
Taxable portion of benefits from first-tier calculation	$7,000

The taxable portion of benefits from the first-tier calculation ($7,000) carries over into the calculation for the second tier to compute the total portion of your benefits subject to taxation.

You should also know that qualified distributions from a Roth IRA do not count toward provisional income. Converting traditional IRA balances to a Roth IRA would increase provisional income in the year of conversion but may reduce provisional income in subsequent years.

Step 3: Second-tier calculation — 85% threshold

The second tier of the formula applies to provisional income exceeding $44,000 ($34,000 for unmarried individuals).

Because your provisional income also exceeds the $44,000 threshold, the excess ($3,000) is subject to the 85% taxation threshold.

Provisional income	$47,000
Less 85% taxation threshold	(44,000)
Excess of provisional income over 85% threshold	$3,000

Step 4: Compute the total taxable portion of benefits

The total portion of your benefits subject to taxation is the lesser of:

85% of Social Security benefits *($14,000 x 85%)*	$11,900
– or –	
The sum of: The lesser of $6,000 *($4,500 if single)* or the taxable portion of benefits under first-tier calculation *($7,000 from Step 2)* and	$6,000
85% of excess *($3,000 x 85%)*	2,550
Total taxable portion of benefits	$8,550

In this example, although more than 50% of your Social Security benefits is taxable, your total taxable income places you in the 10% bracket after the standard deduction and personal exemptions. This is largely because your investment portfolio includes a heavy weighting of municipal bonds that produce tax-free income not counted

You can count on us

Check with your Financial Advisor for advice on structuring a portfolio that lets you keep as much of your Social Security benefits and other income as possible. Your Financial Advisor can work with you and your tax advisor to tailor an investment program to help meet your retirement needs.

when determining your tax bracket. As a result, you could lose $855 ($8,550 x 10%) of your Social Security benefits to income tax. Recipients whose incomes put them in higher brackets could find their after-tax benefits eroded further.

This example illustrates the importance of evaluating your entire portfolio. How it is structured may affect both how much of your Social Security benefits is taxed and the rate.

Enhancing your retirement benefits

If your income exceeds existing taxation thresholds, there may be little you can do to shield your Social Security benefits from taxation. However, depending on how far above the thresholds your income falls, you may have some control over how much of your benefits is taxable.

Your alternatives all center around the sources of your income and your income needs. The more diversified your income sources, the more choices you have. Income limited to Social Security and your pension provides virtually no flexibility for tax savings. If you have investments that generate income, however, you have more choices.

Consider restructuring your investment portfolio

Remember, to determine the portion of your benefits that will be subject to taxes, you must calculate your provisional income, including federal-tax-free interest from municipal bonds. If you reduce your provisional income, you may be able to reduce the amount of your benefits that will be taxed. To do this, you may want to consider tax-deferred investments. Tax-deferred income is not included in provisional income as long as it remains deferred. Some investments that generate tax-deferred income include annuities and certain life insurance policies.

Investors who convert part or all of their investment dollars into tax-deferred investments may find that the reduction in their cash flow does not produce the expected tax savings. This is particularly true for investors whose incomes substantially exceed the thresholds.

This strategy is not for everyone. Your tax savings must be large enough to justify any transaction costs that may result from the investment restructuring. And, perhaps more important, you must be able to live without a portion of the cash flow that your income-paying investments now provide.