

Potential Reforms for the Social Security Program

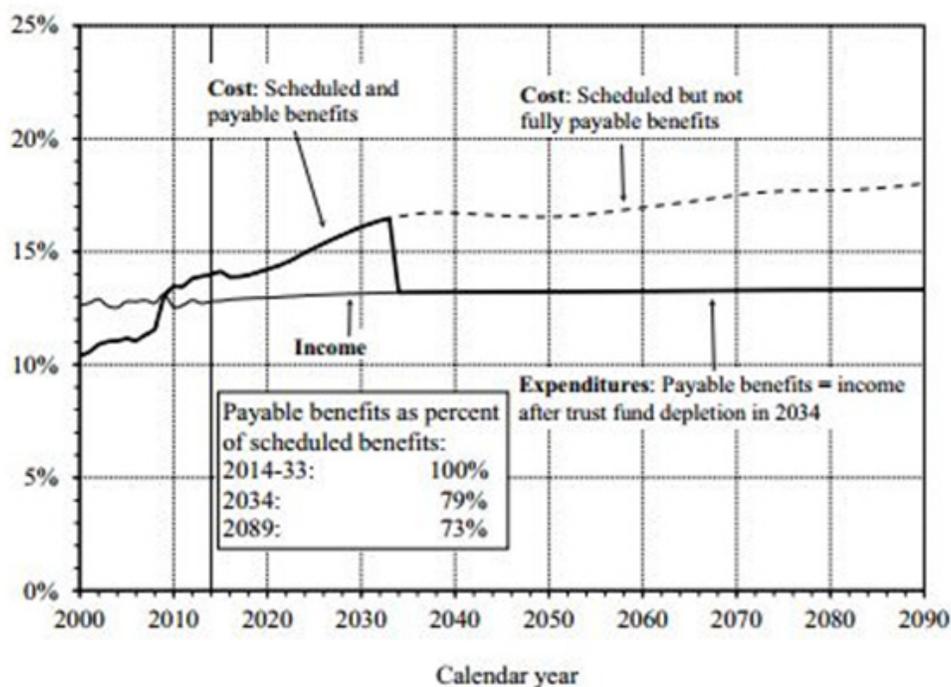
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scheduled amount (Source: 2015 Social Security Trustees' Annual Report). Recent legislation has been passed by Congress under the Bipartisan Budget Act of 2015, which eliminates certain Social Security filing strategies that were previously available to qualifying individuals, effective April 30, 2016. However, this law change did little to restore solvency to the system: the total long-range actuarial deficit is currently 2.68% of payroll, yet the administration projects only a .02% reduction in the actuarial deficit as a result of this 2015 law amendment (Source: 2015 Social Security Trustees' Annual Report; 10/27/2015 letter from Chief Actuary Stephen Goss to Speaker of the House John Boehner).

Social Security is currently in danger of being unable to provide scheduled payments to future beneficiaries. It is estimated that by 2034 the Social Security Trust Fund will be depleted, causing benefit payouts to fall to 79% of their

Figure II.D2.—OASDI Income, Cost, and Expenditures as Percentages of Taxable Payroll
[Under Intermediate Assumptions]



Source: 2015 Social Security Trustees' Annual Report

Because the system is still in need of significant reform, a number of potential solutions are still on the table. No one can predict the exact alterations of the program in the future, but certain measures have gained more attention than others. These measures aim to alleviate the long term Social Security deficit through an increase in revenues, a reduction in costs, or a combination of both.

Raising Revenues

Increase Payroll Tax Rate

The federal payroll tax currently stands at 12.4% of the wage base, split evenly between employer and employee, with the wage base presently at \$118,500 for 2015. We expect that any increase in the payroll tax rate will have an adverse financial effect on all employers and employees. For every 1% increase in the payroll tax, workers would face a .5% decrease in their paycheck. Meanwhile employers will also be forced to pay an additional .5% in taxes on each employee's salary.

Example 1: Bob currently makes \$110,000 a year and pays \$6,820 in payroll taxes in line with his portion of the 12.4% payroll tax. The payroll tax is increased by 2.6%, to a rate of 15%. Bob must now pay \$8,250 in payroll taxes, signifying a 21% increase from his original payroll tax.

Example 2: Steve currently employs 20 workers, each making a salary of \$50,000 per year. Under a payroll tax rate of 12.4%, Steve pays \$62,000 in payroll taxes on behalf of his employees. The payroll tax is increased by 2.6%, to a rate of 15%. Steve now owes \$75,000 in payroll taxes on behalf of his employees, an increase of \$13,000 in taxes.

Increase Social Security Wage Base

The Social Security wage base, currently at \$118,500, determines the amount of a worker's salary that is subject to the payroll tax. A wage base increase would have no effect on individuals making below the current base, but would impact earners above this threshold. The highest income earners would be the most effected as more of their income would be subject to tax. Furthermore, as with an increase in the payroll tax, employers would face an increase in taxes, which would therefore increase with employee salaries.

Example 1: Bob currently earns \$250,000/year and is subject to his portion of the 12.4% payroll tax, applicable to his first \$118,500 in earnings. Under this scenario, Bob owes \$7,347 in payroll taxes. The wage base is increased to \$171,600, but the payroll tax remains the same. As a result Bob now owes \$10,639 in payroll taxes, a 45% increase.

Example 2: Bob's situation is the same, but the wage base has been eliminated completely so that Bob's salary is completely covered by the payroll tax. Bob now owes \$15,500 in payroll taxes, more than double than the \$7,347 payroll tax Bob owed under a wage base of \$118,500.

Change in the Taxation of Benefits

A percentage of an individual's Social Security benefits are subject to federal income tax, dependent on the size of a recipient's "provisional" income*. Currently, the percentage of benefits subject to taxation are 0%, 50%, or 85%, depending on a series of formulas which take into account an individual's income level versus specific income thresholds. Eliminating these income thresholds would allow complete tax coverage of recipient's benefits, regardless of how high or low his or her income is. Under such a reform, taxes paid by beneficiaries with a total income over the current income threshold would remain the same, assuming the percentage of benefits subject to taxation does not change. Other reforms suggest taxing 100% of benefits once an individual's Social Security collections surpasses his or her past contributions. Were this to happen, middle and high income earners could find themselves hit with a significant increase in income taxes later in retirement.

*Provisional Income = modified adjusted gross income + 50% of Social Security income + tax-exempt interest. (Source: ssa.gov)

Example 1: Bob's total yearly income is \$22,000/year, all of which comes from Social Security benefits. Because this amount is below the taxable threshold, Bob does not owe any taxes on his benefits. New legislation eliminates the taxable threshold and sets a 25% tax coverage on the benefits of low income earners. Bob now owes \$825 more in taxes, assuming he has a marginal income tax rate of 15%.

Example 2: Steve's comprehensive income is \$150,000, with \$40,000 coming from Social Security benefits and the remainder from investments. Under this level of income, Steve's benefits are subject to 85% tax coverage. Steve pays \$9,520 in benefit taxes, given his marginal income tax rate of 28%. New legislation, however, does not require Steve to pay taxes on his benefits until he has received as much in benefits as he has contributed in past payroll taxes. Therefore, Steve will receive his \$40,000 benefits tax free for the next 5 years. If Steve dies within these 5 years then no taxes on his Social Security benefits will ever be owed. Thankfully, Steve does live 5 more years while maintaining the same income. In year 6

Steve's benefits outpace his contributions and as a result, he must pay income tax on 100% of his benefits. As a result Steve will save money on taxes up front, but will face higher benefit taxes (\$11,200) in the future.

Lowering Costs

Cut Benefits Across the Board

From a mathematical standpoint, Social Security insolvency can most easily be solved by cutting benefits across the board. These cuts would have to be significant and they would affect all Social Security beneficiaries.

Example 1: Bob's total income consists of \$34,000 a year in Social Security benefits. Assuming benefit tax coverage of 85% and a marginal income tax rate of 15%, Bob takes home \$29,665 in net benefits. In order to return solvency to the program, benefits are cut by 13%. Bob now receives \$2,465 a month or \$29,580 a year in gross benefits. Although Bob now receives less in benefits, Congress did not change any laws regarding the tax coverage of benefits. As a result, only 50% versus 85% of Bob's benefits are now taxable and Bob's after tax benefits become \$27,362. Because of this Bob's benefits have fallen only 8% in value versus 13%. When looking at potential reforms to Social Security it is important to remember the externalities caused by any legislative changes can be positive, such as in the example above.

Modify Social Security Payout Formula

The Social Security payout formula's progressive nature benefits low-income earners proportionately greater than high income earners. This is accomplished through earnings bend points. First, an individual's highest 35 years of income, up to the wage base and indexed for inflation, are averaged to determine the worker's "Average Indexed Monthly Earnings" (AIME). This number is then run through the Social Security formula bend points to arrive at the individual's monthly Social Security benefit at full retirement age, also known as the Primary Insurance Amount.

The following table shows the current bend points, which have increased overtime alongside salaries:

Post Earnings Bend Points	Pay-out % of Past Earnings
Up to \$826	90%
Over \$826 and Under \$4,980	32%
Over \$4,980	15%

A common proposal for legislation suggests altering these bend points and payout percentages in order to lower the amount of benefits received by the system's highest earners. Suggested proposals would not change the lowest bracket point. For instance, the highest bracket payout could be dropped from 15% to 5%. A more aggressive change would be to add another bend point and payout percentage, while lowering all the payout percentages after the first. This idea falls under the concept commonly referred to as "means testing," where an individual's eligibility for benefits is tied to his or her wealth.

Example 1: Bob's AIME is \$9,000 and he would receive \$2,676 a month at full retirement age based on the above table. New legislation decreases the payout percentage of the highest bracket from 15% to 5%. This causes Bob's benefits to fall by 15% to \$2,274.

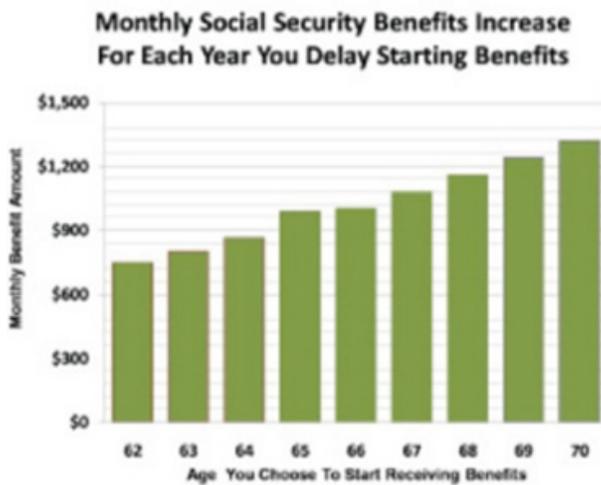
Example 2: Steve's AIME is \$6,250 and it provides him with \$2,263 a month at full retirement age under the current system. New legislation, similar to the 2012 Simpson-Bowles reform, completely changes the payout formula, adding another bend point at \$3,800 and altering the percentage payouts to 90%, 30%, 10% and 5%. Steve's AIME of \$6,250 now provides him with \$1,817 in monthly benefits, a decrease of approximately 20%.

Change Cost of Living Adjustment (COLA) Formula

Social Security benefits are adjusted annually to maintain purchasing power in the face of inflation. This adjustment is made using the Cost of Living Adjustment (COLA), which is tied to the Consumer Price Index (CPI). Because the CPI has been known to slightly overstate inflation due to the fact that consumers will substitute cheaper alternatives as opposed to continue to buy the basket of goods on which the CPI is calculated, tying COLA to a more conservative inflationary measure may more accurately account for changes in purchasing power and decrease program costs. Should a more conservative measure be used, all Social Security beneficiaries would see a slight drop in their benefits. For instance, a .3% decrease in the COLA measure would lead to a .3% decrease in benefits.

Increase Full Retirement Age (FRA)

The Social Security full retirement age is the age at which an individual may begin receiving the full amount of benefits to which he or she is entitled. The FRA changes depending on the year a person was born. For those born between 1943 and 1954 the FRA stands at 66 years old, gradually increasing to 67 for those born after 1954. As a result of increasing life expectancies, many retirees have been collecting benefits longer than anticipated, resulting in proposals to increase the FRA. The potential impact of such legislation is difficult to measure and will depend on each retiree's life expectancy, an impossible number to guess. It is also important to remember that retirees can begin receiving reduced benefits at the early retirement age (62) or increased benefits if they choose to defer benefits until age 70.



Source: <http://www.creditunions.com/article.aspx?articleid=4085>

Change in Auxiliary Benefits

Many beneficiaries of Social Security receive benefits based on another individual's working record. These auxiliary benefits include provisions for low income or non-working spouses, widows, or for beneficiaries with dependents. Spouses can currently receive as much as 50% of their partners' Social Security benefits if their partner is living and 100% if their partner is deceased. Potential reforms seek to lower program costs by lowering these auxiliary benefits.

Example 1: Bob currently receives \$30,000 a year in regular Social Security benefits and his wife receives another \$15,000 in auxiliary benefits. Auxiliary benefits are decreased from 50% to 33% and as a result Bob's wife now receives \$9,900 in benefits. The couple's household income is now \$39,900 rather than \$45,000, a drop of 11%.

Establishment of Individual Accounts

A more radical reform of Social Security is the establishment of individual investment accounts so as to provide workers with greater "ownership" of their benefits. Under this structure, workers would be allowed to allocate some or even all of their Social Security payments to individual accounts where they would be given some investment freedom. In exchange retiree's future benefits may be at greater risk due to potential economic and market volatility as well as insufficient generation of investment income as a result of premature death or disability.

Conclusion

While significant reform is still needed to restore solvency to the Social Security system, it's important to remember that the potential changes listed above are least likely to affect current retirees. And, for those who may be impacted by future reforms, those effects will likely be phased in gradually. While it's beneficial to know about the potential reforms on the table, fear of future reform should not derail a current retiree's Social Security planning strategy. Before making an irrevocable decision, talk with your Wealth Advisor to discuss the optimal collection plan for your unique circumstances.

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This information is based on our current understanding of Social Security legislation that is subject to change at any time. Please consult with a financial advisor of your choosing prior to implementing any of the strategies discussed in this article

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