2010

Social Security Benefits Formula 101: A Practical Primer

Francine J. Lipman
University of Nevada, Las Vegas -- William S. Boyd School of Law

law—meanings which have nothing to do with the general-authority versus specific-authority distinction. Instead, legislative regulations have "force of law" character—they make binding law or change the law—while interpretive regulations merely explain the agency's view of the statute. *E.g., Chrysler Corp. v. Brown*, 441 U.S. 281, 301-02 (1979). Tax regulations that make binding law are legislative whether they are promulgated under specific authority or general authority. The temporary regulations at issue clearly are legislative; their point was not to explain the Service's view of section 6501 but to change the law by administratively reversing the law as articulated by the adverse cases.

The Service's argument that Congress excepted temporary tax regulations from APA notice-and-comment is better but probably not good enough. The argument is based on inference, not explicit text. Yet Congress has provided that other statutes may modify APA requirements only expressly, not impliedly. 5 U.S.C. § 559.

The arguments advanced in the other *Intermountain* opinions do not strike me as persuasive. First, as pointed out by Judges Halpern and Holmes, the regulations' effective date provision is ambiguous, not plain. The provision might be read to mean "open under the normal three-year period," as the *Intermountain* majority read it, or it might mean "open under the six-year period, as that period is extended by this regulation," as Treasury and the Service intended. An agency's construction of its own ambiguous regulation is entitled to deference. *E.g., Auer v. Robbins*, 519 U.S. 452, 461 (1997); *Stinson v. United States*, 508 U.S. 36, 44-46 (1993).

Second, the majority likely is wrong as to its *Chevron* Step One analysis. *Colony* itself did not say that its result was unambiguously commanded by the statute. Moreover, *Colony* construed a predecessor of current section 6501(e), and the current statute arguably is somewhat more congenial to the Service's position. Finally, as noted in the Fall 2009 article, the Service won a number of the cases after *Colony* but before 2009. There are two possibilities. Either the courts holding for the Service failed to notice that *Colony* had settled the issue, or the *Intermountain* majority overplayed its hand in characterizing *Colony*'s holding. I think that the second of these alternatives better states the matter.

Third, the narrow ground offered by Judge Cohen and the judges joining her is dubious. Yes, a statute outranks a regulation. But a validly promulgated legislative regulation has force of law status. Thus, the distinction offered by Judge Cohen's concurrence is not a meaningful difference.

Predictions

The Tax Court's *Intermountain* decision surely is not the last shot that will be fired in the overstated basis statute of limitations battle. The Government may appeal *Intermountain*, and the validity and applicability of the new regulations will surely be tested in other cases in the future.

Based on the above analysis, the temporary regulations should continue to be invalidated. However, when they have been finalized after completion of notice-and-comment, the regulations should be upheld, particularly if applied only prospectively. Taxpayers who already have won their cases should be safe, but taxpayers whose cases have not yet been decided will be in jeopardy.

Social Security Benefits Formula 101: A Practical Primer

By Francine J. Lipman* and James E. Williamson†

Social Security benefits redistribute income broadly and deeply every month across America. One out of every four households and one out of every six Americans receive these critically important benefits. Almost 52 million beneficiaries receive monthly Social Security payments averaging more than $13,000 annually. While almost all seniors receive Social Security benefits, millions of children and people with disabilities also receive payments.

As these statistics demonstrate, Social Security has been one of the most successful programs in the history of America. The broad distribution of meaningful monthly benefits lifts and keeps millions out of poverty. Social Security benefits keep 40% of seniors out of poverty as well as more than one million children. These benefits are the major source of income for 52% of senior couples and 73% of senior singles and represent 90% or more of income for 21% of senior couples and 44% of senior singles (47% of senior women).

* Professor of Law, Chapman University Law School, Orange, CA.
† Professor of Taxation and Accounting, San Diego State University, San Diego, CA.

Despite the broad and deep reliance on Social Security benefits, very few of the hundreds of millions of current and future beneficiaries understand how the program works. This article will present through a hypothetical couple some of the basics of the Social Security benefits formula.

Please consider the following (perhaps all too familiar) taxpayers:

Maria and John graduated from law school in 1973 at 25 years young. As tax lawyers in love, they married and practiced tax law. After the birth of their second child, they decided that John

Table 1

Year of Birth	FRA and Full Benefits	Age 62 Benefits As % of FRA Benefits
1937 or earlier	65	80
1938-1942	Varies (increases by 2 months for each year)	Varies (decreases by 0.83% for each year)
1943-1954	66	75
1955-1959	Varies (increases by 2 months for each year)	Varies (decreases by 0.83% for each year)
1960 and later	67	70

should quit his job and be a stay-at-home parent. Except for two maternity leaves of six months each, when the children were born, Maria has worked continuously until the present time.

Because they are now 62 years old, they have received evaluations of their Social Security retirement benefits, called the primary insurance amount (PIA). At this time they have to make their first decision about their Social Security benefits. While full retirement age (FRA) for Maria and John is age 66, they may elect a reduced Social Security benefit as early as age 62.

Had John and Maria been born a few years earlier, their age 62 benefits would have been a larger percentage of FRA benefits and their FRA would have been age 65. The Social Security Administration has implemented certain changes enacted by Congress in 2000. These changes will increase FRA from 65 to 67, while the percentage of full benefits paid to people retiring at the earliest retirement age (62) is being reduced over time from 80% to 70% of PIA. These rules are illustrated in Table 1.

PIA is the monthly benefit at FRA. If a beneficiary elects to start benefits early at age 62, she would receive 75% (70% for those born in 1960 and later) of her PIA. If she elects to defer starting her benefits until age 70, she would receive the maximum amount of Social Security benefits or 132% of PIA (8% guaranteed increase for annual deferrals beyond FRA). If she elects to defer starting her benefits to any age after 62, the PIA will be increased by any annual cost of living adjustments (COLAs).

The Basic Social Security Retirement Benefit Formula (www.ssa.gov/estimator/)

The Social Security system was designed to provide a financial retirement safety net for workers and their dependents. Accordingly, lower and middle wage earners receive a much greater percentage benefit (as compared to the cost percentage (or effective tax rate)) than higher wage earners. Social Security benefits are computed using a worker's average wage-indexed monthly earnings (AIME) on which Social Security taxes were paid during the 35 highest qualifying earning years. PIA includes 90% of the first level of AIME (up to $761 for those attaining age 62 in 2010). The second level of AIME (from bend point one to bend point two) is included in PIA at 32%. The third level of AIME is measured from bend point two to the Social Security taxable earnings ceiling. PIA includes only 15% of this amount. This calculation is illustrated for Maria, who would have the highest possible AIME of $7,948 in 2010 ($95,376, maximum average/wage-indexed annual earnings that have been subject to Social Security tax for the last 35 years).

A worker paying the maximum amount into the Social Security system for 35 years prior to 2010 would receive a monthly PIA of $2,413 ($28,956 annually). However, an average wage earner paying into the Social Security system on AIME of $4,586 ($55,032 annually) would receive a monthly benefit of $1,909 ($685 + $1,224) ($22,908 annually). These two benefit levels illustrate the cost/benefit advantage to an average wage earner. The higher wage earner receives only 23% more per month ($504) than the average wage earner while having paid 73% more in Social Security tax.

Because Maria has paid the maximum Social Security tax for more than 35 years, her PIA is $2,413. If we assume John paid in the maximum Social Security tax for each year that he worked, but only for ten years, his PIA will be based on an AIME of no more than $2,271 (10/35 x $7,948). Therefore, John's PIA is:

PIA = (761 x 0.90 = 685) + ((2,271-761) x 0.32= 483) = $1,168.

Although John paid only 27% (10/37) of the amount of Social Security tax that Maria paid, his PIA is almost 50% of her PIA. This is a result of the 90% and 32% benefits on lower amounts of AIME. The Social Security benefit formula was designed to provide an antipoverty safety net for middle and lower wage earners and their families. The Medicare system similarly provides a health care safety net. Every person who qualifies for Medicare benefits receives exactly the same benefits regardless of the amount of Medicare tax paid.

Table 2

Calculation of PIA for Workers Attaining Age 62 in 2010

	First Bend Point		Second Bend Point		Maximum AIME
	$761		$4,586		$7,948
Range	(761 x 0.90)	+	((4,586 – 761) x 0.32)	+	((7,948 – 4,586) x 0.15)
PIA	685	+	1,224	+	504 = $2,413

The Election to Start Social Security Retirement Benefits

More than 70% of recipients receive reduced benefits because they elected to start benefits before their FRA. Based on their respective PIAs, and disregarding potential COLAs, benefits at the various election dates for Maria and John would be:

Table 3

Age	62	66	70
Maria	$1,810	$2,413	$3,185
John	$ 876	$1,168	$1,542

One of the traps for the unwary in the early retirement benefits election is that, for any year in which you are younger than FRA and continue to have earned income, you must pay back $1 of your benefits for each $2 that you earn above $14,160 (indexed annually). In the year that you reach FRA, you must pay back $1 for each $3 that you earn above $37,680 (indexed annually), until the month that you reach FRA. Once you reach FRA, you may earn as much as you are capable of without a benefits payback penalty. For many workers who elect to start their Social Security benefits at 62, the sacrifice includes not only reduced benefits (75% of PIA), but also lost wages during these pre-FRA years.

Unless Maria decides to retire from practicing tax law, there would be no reason to elect to receive her benefits before her FRA. Alternatively, if John is not working in a position where he earns more than $14,160 per year, he may want to start his Social Security benefits at age 62. No matter how much Maria earns during these years, it would not affect John's benefits. Therefore, Maria and John might decide that John should start his benefits at age 62 ($876) and Maria should start her benefit at FRA ($2,413) or even at age 70 ($3,185).

Once Maria retires, John could begin collecting his spousal Social Security retirement benefits, which would be 75% of half of her benefit (0.75(0.5 x 2,413) = $905, or 0.75(0.5 x 3,185) = $1,194). If Maria and John have unmarried children (or dependent grandchildren) who are younger than age 18, full-time students (grade 12 or below) or disabled (before age 22) when they start their Social Security benefits, each child will qualify for up to half of the highest retiree's FRA benefit. However, the family cannot exceed a maximum family benefit—generally between 150% and 180% of the retiree's benefit. If a family beneficiary works, the payback penalty applies to her benefits based upon her earnings record.

Surviving Spousal Benefits

Regardless of whether John continues with his own benefits or switches to a percentage of Maria's benefit, should she die before he does, he will be able to claim 100% of her Social Security benefits as a surviving spouse. Because of this generous surviving spouse benefit, the spouse with the highest PIA should consider seriously delaying starting Social Security benefits as long as reasonably possible (up to age 70 when the benefit is capped at 132% of PIA).

Because they were married for more than 10 years, John's spousal benefits are unaffected even if Maria and John divorce. This is true even if Maria remarries. However, if John remarries before age 61, he cannot collect spousal benefits on any former wife's employment record while he is married. If John becomes single again (through divorce or death) or remarries after age 60 (50 if disabled) he will be able to collect Social Security benefits on Maria's work record.

Other Factors to Consider

The discussion in this article focuses solely on Social Security benefit levels. Decisions regarding Social Security are further complicated by the section 86 computation, which determines the percentage of benefits included in gross income. A related issue involves whether to apply for Medicare participation at 65 or continue participating in an employer-provided plan. The employer-provided premiums are generally excluded from the employee's gross income under section 106; the exclusion does not vary based on the employee's age or income. Medicare premiums, on the other hand, are an out-of-pocket cost and are means-tested. For more extensive coverage of these considerations, see Francine J. Lipman, *Shrinking Boomer Social Security Retirement Benefits*, NEWSQUARTERLY, Fall 2007, at 19.

Conclusions

As you have discovered, the Social Security benefits formula is complex and riddled with critically important decisions. Understanding how the Social Security benefits formula functions is necessary if you are to make the best decisions for your family, clients, and yourself. Millions of beneficiaries take early and substantially reduced Social Security retirement benefits. This election can result in years of regret because of inadequate cash flow to maintain an acquired or even subsistence retirement lifestyle. The worker's decisions not only affect her benefits, but the benefits of spouses, ex-spouses, and children. Because the future is so uncertain, especially given the risks in financial and real estate investment markets, a conservative approach would be best for many beneficiaries to minimize risk. Government guaranteed Social Security benefits are high return, low risk and life-saving investments for (too) many millions of beneficiaries. ▪