Social Security and Medicare

A Primer

By Charles M. Russman

Social Security and Medicare are important. You are working and paying—or have worked and paid—your hard-earned money into the system, and you should understand how it operates. Social Security and Medicare are complex, filled with confusing options that require explanation to empower you to make decisions that will greatly affect your retirement. By briefly exploring the rules and options and when and how some choices need to be made, this article provides you with sound footing and greater confidence when talking about and taking action on your Social Security and Medicare benefits.

Taxes

The first step in understanding Social Security and Medicare is knowing how and why benefits are earned. Social Security is funded by a tax known as the Federal Insurance Contribution Act (FICA),[1] which has two components. The first tax is at a total rate of 12.4%, half paid by the employee through a deduction from wages and half by the employer. Those who are self-employed pay the full 12.4%, which is often referred to as self-employment tax. This first tax is paid only on the applicable amount. In 2015, this amount is $118,500, which means the most that can be paid is $14,694 ($14,694 = $118,500 × 0.124 (12.4%))—$7,347 paid by the employee and $7,347 paid by the employer. The applicable amount is adjusted annually, when necessary, by the Social Security Administration.

The second component of FICA is smaller and funds Medicare. This second tax is at a total rate of 2.9% and is also paid half by the employee and half by the employer. As with the first part of the tax, those who are self-employed are obligated to pay the entire 2.9%. Unlike the first part of the tax, this smaller amount is paid on all earned income, no matter how much you earn. Additionally, under the Patient Protection and Affordable Care Act, this second tax is increased by 0.9% on income in excess of $250,000 in adjusted gross income for those who are married and filing jointly; $125,000 for those who are married and filing separately; and $200,000 for all other individuals.

More specifically, a Social Security benefit is calculated based on the amount paid into the system; even after one has earned its maximum benefit, the tax must still be paid. In this regard, Social Security is like a pension plan or defined benefit plan: there is a promised benefit that must be paid, regardless of how much or little is paid into the system, unlike a 401(k) or defined contribution plan where the benefit is equal to the amount contributed to the plan. This variance has led to the nearly constant concerns that Social Security funding is insufficient to pay all the promised benefits, causing headlines (sometimes based on governmental agency reports) about Social Security going bankrupt in the future.

With this background, let's move on to what many see as the more pressing issue: what to do about taking one's own Social Security benefits. Individuals may choose from a variety of options. The following is a summary of those options and should not be construed as advice. One should consult with a financial, tax, or other personal advisor before making decisions about Social Security and Medicare benefits.

Income: earning and receiving a benefit

Over the history of Social Security, how you earn a benefit and the amount of that benefit have varied. Rather than focus on history, this article looks at the current earnings structure. Social Security benefits are based on the number of credits received during employment. Each year, up to four credits can be earned. A credit is received for every $1,220 earned in a calendar year. To receive Social Security benefits, most individuals need 40 credits, which is about 10 years of credits at four credits per year. Social Security benefits are normally received upon disability. There is a sliding scale for how many credits are necessary to receive benefits upon disability:

- Those who become disabled before age 24: six credits in the three years preceding the disability.
- Those who become disabled between 24 and 31: half of the period between age 24 and the age of disability. For example, if one becomes disabled at age 30, 12 credits would be required, which is half of the maximum 24 credits that could be earned during that period.
- Those between age 31 and 42: 20 credits.
- For each two years in age over 42: an additional two credits up to 40 credits at age 62. For example, at age 50, 28 credits are required and at age 58, 36 credits are required.

Once an individual has started taking benefits, income may still affect the amount of the benefit—and not necessarily in a positive way. That is, for years in which benefits are taken and one has not reached full retirement age (defined below), there is a one-dollar reduction in benefits for every two dollars earned. This reduction applies only to certain income and, as of this year, only when more than $15,720 in income is earned. There is a one-dollar reduction in benefits for every three dollars earned for the year one reaches full retirement age. Finally, for those who retire midyear, income earned before retirement is often disregarded for Social Security benefit reductions.

FAST FACTS

For those earning income while receiving Social Security benefits, 50% or 85% of Social Security benefits may be taxable.

In one's early 80s, the amount received from the earliest, normal, and latest start dates levels out, but after this time, the increased payment from delaying when benefits start will continue to be worth more.

For most people, failure to sign up for Medicare parts B or D results in penalties based on the amount of time that has lapsed since coverage could have first been elected.

Full retirement age, and when benefits can or must begin

Full retirement age is the age at which there is no reduction or increase in one's Social Security benefit. The age varies based on the year of one's birth, with five main categories. The following chart shows the categories.

Year of birth	Full retirement age
1937 or earlier	65
1938	65 and 2 months
1939	65 and 4 months
1940	65 and 6 months
1941	65 and 8 months
1942	65 and 10 months
1943–1954	66
1955	66 and 2 months
1956	66 and 4 months
1957	66 and 6 months
1958	66 and 8 months
1959	66 and 10 months
1960 or later	67

The earliest a benefit can be taken is at age 62. If benefits are taken before full retirement age, there is a reduction in benefits. Social Security benefits must begin by age 70. If benefits are taken after full retirement age, there is an increase in benefits.

Reduced and increased benefits: scope and considerations

How much an individual's benefit is reduced depends on how early the benefit begins and when he or she reaches full retirement age. For convenience purposes, the remainder of this discussion is based on a full retirement age of 67 unless expressly stated otherwise. Taking a benefit early means a lower monthly benefit, but one would still receive benefits for life. The following chart shows the percentage of an individual's full retirement age benefit that would be received, depending on the age at which he or she starts receiving benefits.

Age when benefits begin	Percentage of full retirement age benefit received
62	70%
63	75%
64	80%
65	86.7%
66	93.3%
67	100%
68	108%
69	116%
70	124%

Opinions vary regarding when a benefit should be taken, and personal circumstances play a major role. From a mathematical perspective, an individual taking the benefit at age 62 would need to live about 18 months beyond his or her life expectancy to receive the same benefit he or she would have received if the benefit was taken at age 67 and the individual lived only until life expectancy. Based on current life expectancy, this means living to approximately age 81. An individual waiting until age 70 to take the benefit would need to receive benefits until age 82½ before receiving a larger benefit that he or she would have received by taking the benefit at 67. While this may appear to mean one will break even upon reaching his or her mid-80s, that is not the case. In reality, in one's early 80s, the amount received from the earliest, normal, and latest start dates levels out, but after this time, the increased payment continues to be worth more, resulting in notably more benefits with time. The longer one lives, the more this difference compounds.

There is one more consideration: taxation. For most people, a good portion of Social Security benefits are taxable. While the amount can vary, in most circumstances either 50% or 85% of Social Security benefits are taxable. For those with income in 2015 between $25,000 and $34,000 for an individual or $32,000 and $44,000 for a married couple filing jointly, 50% is taxable. For those with income in 2014 over $34,000 for an individual or $44,000 for a married couple filing jointly, 85% is taxable.

Spousal considerations

For married individuals, additional considerations include the spouse's benefit, former spouses, and when the couple should file for and start taking benefits.

A married individual is entitled to a Social Security benefit equal to the greater of the individual's earned benefit or half of his or her spouse's benefit. Spousal benefits that begin before full retirement age are reduced. For one's spouse to receive a spousal benefit (half the benefit of his or her spouse), three requirements must be met: (1) the spouse must be at least 62 years old, (2) the couple must be married for at least one year, and (3) the individual on whose earnings the spouse's benefit is based must have filed for Social Security benefits even if benefits were not yet started.

This concept of file and suspend—in which one has filed with the Social Security Administration for benefits after full retirement age but, to maximize the benefit received, waits to receive benefits until a later time not to exceed age 70—can have significant benefits. Filing and suspending enables one's spouse to elect spousal benefits, which means each spouse can temporarily receive a benefit equal to half the other spouse's benefit while allowing his or her own benefit to continue to grow, up to age 70. One consideration for file and suspend is its effect on paying for Medicare. For file and suspend, the issue is if an individual is not receiving Social Security benefits but is receiving Medicare benefits, the cost of Medicare needs to be paid out of his or her other assets (once Social Security benefits are received, Medicare costs normally come out of one's monthly Social Security benefit payment). Former spouses are also entitled to benefits if (1) the former marriage lasted at least 10 years, (2) the former spouse is at least 62 years old, and (3) the former spouse did not remarry. While this does not affect one's own benefit, it is something that should be considered in divorce proceedings.

Medicare

Medicare, which is paid out of the same taxes as Social Security, can be just as complex as Social Security. Before going into more detail about the parts, coverage, costs, and other aspects, it is important to remember that, unlike Social Security, which is entirely federal, Medicare is part federal and partly managed and defined by the state.

The easiest way to understand Medicare is to consider it part by part. Part A is hospital insurance, which covers hospital stays and related treatment, nursing-home care, and hospice. It is provided at no cost to most individuals if they paid employment taxes. Part B is coverage necessary for the prevention and treatment of illness or disease. Individuals pay a portion of the cost of Part B, and for those already receiving Social Security benefits, the amount is normally deducted directly from the benefit before it is received. For most individuals, Part B costs approximately $105 per month with an annual deductible of approximately $150. Most people sign up for parts A and B in the seven months surrounding age 65 (the three months before turning age 65, the month one turns age 65, and the three months after turning age 65). For most people, failure to sign up for Part B during this time will result in a penalty of a 10% increase for each 12-month period signing is delayed. This penalty is applied to the Part B rates for all years in which one receives Part B coverage, not only the first year.

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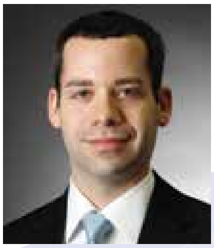
Part C, commonly known as Medicare Advantage, is optional private insurance approved by Medicare and designed to supplement coverage provided by parts A and B. For example, many Medicare Advantage programs include additional medical, vision, dental, auditory, and prescription drug coverage. Unlike parts A and B, in which the benefits are standardized, Medicare Advantage is more personalized and offers an array of options within the range of what Medicare approves. The costs vary based on an individual's location, the scope of benefits, and who the provider is, among other factors.

Part D, which is also optional, covers prescription drugs. Like Medicare Advantage, Part D is provided by private companies who have applied to and been approved by Medicare. As with Part B, individuals incur a penalty for failing to sign up for Part D when the first opportunity arises; for each month one goes without Part D (and later enrolls for Part D) beyond 63 days, the penalty equals the number of months without coverage multiplied by 1% of the national base beneficiary rate, which is $33.13 in 2015. Medicare Advantage and Part D require annual enrollment, which occurs between October 15 and December 7.

Medicare has far fewer options than Social Security, but it poses important questions, including whether one wants or needs Medicare Advantage or Part D. Although these are optional, the costs of healthcare if Medicare Advantage is not received and the penalties associated with Part D make the choice an important one.

Conclusion

Social Security and Medicare are complex, technical benefits, but their importance makes it worth taking the time to understand them. This article was intended to provide a brief overview and allow readers to better understand what they have worked (or are working) hard to earn. Contact your financial planner, accountant, tax lawyer, or other consultant for additional information, or visit www.ssa.gov and www.medicare.gov. ■



Charles M. Russman is a member of Bodman PLC. He has extensive experience with virtually every type of employee benefit and executive compensation. He assists clients with regulatory compliance regarding HIPAA, the Affordable Care Act, the Internal Revenue Code, ERISA, COBRA, and governmental benefits (including Social Security and Medicare) and frequently speaks on healthcare reform, HIPAA, and other employee benefit, executive compensation, and privacy concerns.

ENDNOTE

1. 26 USC 1400 *et seq.*