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The Million Dollar Question

How Can Married Couples Maximize Social Security?

By Kathleen Gilmore, CFP®

Of all the assets available to support retirement, Social Security benefits are often the last to be included in strategic conversations. We spend decades building our net worth and a lifetime planning for the effective use of our assets in supporting our evolving lifestyles and goals. Yet, too often, our decision to begin taking our Social Security payments is based solely on age-related eligibility. Perhaps this is because we do not believe that there is much we can do to affect our future cash flows from Social Security. Perhaps we underestimate the lifetime value of this asset, especially as it compares to our investment portfolios.

The lifetime value of Social Security can be significant. If a single-career professional couple, both age 66, take Social Security benefits of $3,000 per month at full retirement age for the earner and $1,500 per month in spousal benefits, they will receive over $1 million if they both live to 85. And that's not including Social Security's annual inflation adjustment, which has ranged as high as 14.3% in 1980 to a low of 0.0% (2009 and 2010).

In comparison to individuals, the decisions surrounding when and how to claim Social Security benefits are especially complex for married couples, and every case is unique. Factors such as the age and health of each spouse, expected benefits, other sources of retirement cash flows, and ability and willingness to continue working can dramatically affect the value of Social Security over a lifetime. But with thoughtful, proactive planning, Social Security can represent a million dollar asset for married couples who understand the strategies and options available to them.

Social Security: Key Concepts

To consider the optimal claiming decision for a couple, it is important to understand some basic concepts of the Social Security benefit formula.

Primary Insurance Amount (PIA): Assuming that an individual has at least 10 years of qualified earnings, retired worker benefits are based on the highest 35 years of earnings for that individual. A monthly average for these earnings is indexed for economy-wide wage growth and then subjected to a formula that produces the worker's PIA. The PIA is the monthly benefit the worker can receive if he or she claims Social Security at full retirement age.

Full Retirement Age (FRA): There are three important ages that affect Social Security choices: age 62, Full Retirement Age (FRA), and age 70. Retirement benefits are not available before age 62.

Full Retirement Age is the age, based on birth month and year, when an individual will receive the full PIA monthly benefit. The FRA currently ranges from age 65 to 67. Claiming benefits between age 62 and FRA will result in a *reduction* in benefits. For example, individuals with a full retirement age of 65 that claim benefits at age 62 have their payments reduced to 80 percent of PIA. For those with a FRA of 67, claiming benefits at 62 reduces monthly payments to 70 percent of PIA.

Alternatively, an individual may decide to delay claiming benefits past FRA and receive a delayed retirement *credit* for each month of delay up to age 70. For individuals born in 1943 or later, this credit amounts to an additional 8% of PIA per year of delay.

When faced with the decision about when to take Social Security, we focus our planning for married couples around these three age milestones and the relative difference in ages between the spouses. We also make note of two additional benefits: spousal and widow.

Spousal Benefit: A married person can receive a spousal benefit equal to half of their spouse's PIA *only if* the earning spouse has claimed worker benefits and the spouse is no younger than his or her FRA. Spousal benefits *do not* increase based on worker claims made past FRA, but they do decrease if the spouse claims benefits before FRA.

Widow Benefit: In contrast, widow benefits *do* increase based on worker

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claims made past FRA, and they have a floor to any decreases based on worker claims before FRA. A widow or widower may receive a benefit equal to either 82.5 percent of the deceased spouse's PIA or the deceased spouse's actual benefit, whichever is greater.

Example: Joe's PIA is $1,000 per month, but he originally elected to receive benefits at age 62, which reduced his monthly benefit to $750. After his death, his wife may claim a widow's benefit of $825 per month (82.5% of PIA), which is greater than the retirement benefit originally claimed by Joe. If Joe had delayed his original benefit claim by one year past his FRA to secure a $1,080 monthly benefit (8% increase to PIA), his widow would be able to claim the full $1,080 monthly benefit.

Maximizing Strategies

Armed with these concepts, let's look at two tactics married couples can use to maximize the two-life Social Security benefit.

File and Suspend

As previously stated, current law does not allow a spouse to claim a spousal benefit unless the main beneficiary (the "worker") claims benefits first. Enacted in 2000, the file and suspend provision allows a worker to file for his or her own benefit at FRA (or later) and then suspend the benefit until a later time. Because the worker has filed, the worker's spouse can claim a spousal benefit while the worker's retirement benefit grows at 8 percent per year until age 70.

Example: Chris and Pat are a *single-career* professional couple, both aged 66 (their FRA), with a current claim of $3,000 in worker's benefits and $1,500 in spousal benefits. If Pat, the worker, files and suspends, Chris starts collecting $1,500 in spousal benefits at age 66 and Pat collects nothing for the time being. If Pat suspends the retirement benefit until age 70, the benefit will grow to almost $4,000 per month (an increase of 8 percent per year from age 66 to 70). If Chris survives Pat, Chris's widow/widower benefit will be equivalent to the value of Pat's benefit (approximately $4,000).

Restricted Application

If a couple is a *dual-career* couple, the restricted application strategy provides even more opportunities to maximize benefits. When one working spouse reaches FRA, they have the option of filing a restricted application *for spousal benefits only*, while allowing their *worker benefits* to continue to grow until age 70. The restricted application option is generally most effective when the higher earner utilizes it to claim spousal benefits only, while the lower earner claims full retirement benefits.

Example: *Dual-career* couple, Alex and Blair, are both 66 and at FRA and have Social Security benefits based on their work histories of $3,000 per month (Alex) and $1,500 per month (Blair). Alex claims spousal benefits of $750 (half of Blair's retirement benefits) while Blair claims $1,500 in worker benefits. Alex, in effect, has claimed "free" spousal benefits while delaying worker benefits while they grow until age 70.

You might wonder what prevents both Alex and Blair from filing and suspending and then claiming spousal benefits while their worker benefits grow until age 70. According to the Social Security administration, "only one member of a couple can apply for retirement benefits and have payments suspended so his or her current spouse can collect benefits." For married couples, spouses can choose to claim either their own earned (worker) benefits or spousal benefits, but not both.

In effect, the *file and suspend* option is a current claim for worker benefits even though payments are deferred, while the *restricted application* is a claim for spousal benefits and is dependent upon the other spouse claiming their retirement benefits.

The choice as to which strategy is appropriate for a couple is not always an obvious one. Generally, when planning to maximize Social Security benefits, the odds favor one spouse outliving the other. Since the surviving spouse will receive the larger of the widow benefit or their own retirement benefit, maximizing the higher earner's benefit makes sense. For couples with longer life expectancies and current cash flows, utilizing both the file and suspend and restricted application options may be best.

Example: Alex and Blair, from our previous example, both have great health and family histories of longevity. At age 66 they receive sizeable inheritances. With minimal need for current additional income and a desire to maximize lifetime benefits, Alex decides to file and suspend while Blair uses a restricted application for spousal benefits only and begins collecting $1,500 in spousal benefits (one half of Alex's $3,000 retirement benefit). Both spouses' worker benefits are deferred until age 70, thereby increasing these benefits to nearly $4,000 for Alex and almost $2,000 for Blair, whose spousal benefits end with this transition.

From this last example, we see how health and other income resources are also important factors in devising an optimal claiming strategy. There are also special considerations for divorced spouses that should not be overlooked, but are beyond the scope of this article. The bottom line is that your Social Security benefits should be viewed as a strategic asset in your overall retirement plan, and, like your investment portfolios, deserve a thoughtful and individually tailored approach. ◆

Noise, Noise, Noise!

By Thomas A. Moritz, CFA

How can an investor monitor political developments, listen to business news, analyze company data and try to follow it all closely enough to make sensible investment decisions? If attuned to every piece of information and detail of macroeconomic and microeconomic news, an investor would analyze his or herself into hyper-sensitivity and portfolio destruction or decision-making paralysis. The “noise” could be deafening and the useful “signals” lost in a cacophony of chaos.

> **“From an investment perspective, distinguishing important information from sensationalized news in media is critical.”**

In his book, *The Signal and the Noise,* statistician Nate Silver explores why it is difficult to differentiate the signal from the noise, explaining that “the instinctual shortcut that we take when we have ‘too much information’ is to engage with it selectively, pick out the parts we like and ignoring the remainder[…].” From an investment perspective, distinguishing important information from sensationalized news in media is critical. We are not in the business of predictions, but as we endeavor to prudently manage clients’ investment portfolios, distinguishing the signal from noise allows us to orchestrate an appropriate investment process.

Consider the potentialities of the recent Ebola breakout. The proliferation of rapid fire, viral news flow ensured that the fear of the disease would be widespread. Could Ebola be the modern day Black Death, a black swan event that unravels us? Experts from many fields have chimed in with opinions. The frightening news must not be ignored, but Ebola is an evolving crisis with an unknown conclusion and unclear economic impact. We have not made meaningful portfolio adjustments and think the probabilities suggest little long-term economic impact. That being said, a black swan event—a low-probability event whose occurrence would have a high-magnitude impact—is the most alarming type of event and the hardest to predict (the probability of occurrence lies in the tails of the probability distribution, far from the mean). Rather than attempting to predict something so rare, our approach would be to monitor such a situation and make necessary changes to investment portfolios as the eventuality is revealed.

Time will tell. Time might be the greatest friend to investors, while market timing might be the greatest foe. As an example, consider the hugely negative impact of fear-based investment timing decisions. In Silver’s book, the temptation to time the market is challenged—a 1970 investment of $10,000 in the S&P 500 would have yielded $63,000 in profit by 2009, but if one adopted the strategy of pulling out money when the market dropped by 25% and putting it back in when it had recovered to 90% of its earlier price, the profit would be only $18,000. Many investors behave in the latter fashion.

Some information is more useful in portfolio strategy. A more predictable event with significant data from past results could be more useful in adjusting portfolios. In statistical analysis, as a sample size gets larger, the distribution becomes more normal, and therefore, predictable. Since the sun has risen every morning of our lives, we are willing to predict the sun will come up tomorrow.

Can we sift through the data, avoid the noise and identify some signals that might improve the risk/reward relationship in clients’ portfolios? Looking at another recent news topic, let’s consider the impact of the November mid-term elections. Historical data suggests that from a presidential election cycle standpoint, the market’s best returns may lie ahead. In his 2004 article, “Presidential Elections and Stock Market Cycles,” Marshall Nickles found that all the major market declines from 1950 to 2004 occurred during the first or second years of the four-year U.S. presidential cycle. No major declines occurred during the third or fourth years. More, specifically, from 1950 to 2004, the most favorable period for investing was from October 1 of the second year of the presidential to December 31 of the fourth year.

A look at the average returns for each of the years in the 4-year election cycle between 1948 and 2007 shows this pattern:

4-Year U.S. Election Cycle (1948-2007)

Year	S&P 500 Return
1	7.3%
2 (Midterm Elections)	10.1%
3	22.3%
4 (Presidential Election)	12.6%

Are these results random or due to politics and a backdrop of more favorable

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fiscal policy? A possible explanation could be a looser spigot of spending later in an elected term by politicians in a bid to get reelected. After a presidential election has passed, the spending belt may get tightened. Either way, the data supports a more positive view seasonally. The presidential cycle theory was developed by market historian Yale Hirsch. The key assumptions are:

- Markets do well in a presidential election year.
- Markets do even better in the year leading up to the election.
- Markets perform best in years three and four of the current term.
- Markets perform worst in years one and two of the new term.

This data is compelling, but is it predictive? Is it a signal or is it noise? The sample size is relatively large. So, based on our current position in the presidential cycle, we are seemingly in the sweet spot for equity investment. But at the same time, the stories in the news skew negative: Ebola, the economy, interest rates, ISIS, etc. Noise, noise, noise!

At Clifford Swan, the majority of our research work is bottom-up, company-by-company analysis. We will continue to do our fundamental work. But if an edge can tilt the risk/reward to our clients' advantage, we will investigate it. The mid-term elections are behind us, and by the time the newsletter is out, we will know more about Ebola (a vaccine?), and will be in what has historically been a seasonally strong period for equities (November–January).

There is so much noise amid the signals, making the difference difficult to recognize. Having a plan, working with your advisor(s), and some benign neglect, with respect to your well-constructed portfolio, may yield the best results. The seeds have been planted, let them grow.

As always, we look forward to serving your investment needs. ◆

Yearend Charitable Giving Considerations

By Ken Dike, Esq., CPA, CLPF

As we approach the end of 2014, there are several charitable deduction issues to consider, a few of which will be discussed in this article. First, as in 2013, the IRA charitable rollover tax provision for 2014 has yet to be extended at this late date. Secondly, did you know that you could "gift" the future payments you are entitled to receive from charitable remainder trusts and gift annuities? This article will attempt to explain these unusual types of "gifts" and how their charitable deduction is calculated. Lastly, a brief summary of the rules used to determine the date of a charitable contribution is included for your yearend planning.

Pending IRA Charitable Rollover Provision

The charitable IRA rollover provision of the Pension Protection Act of 2006 allowed IRA owners who were at least 70 ½ to transfer a maximum of $100,000 to a public charity without recognizing any taxable income. Although the transfer was not taxable to the IRA owner as income, it did qualify as the owner's annual required minimum distribution (RMD). Only IRA plans qualified for this special treatment which excluded simplified employee plans (SEPs), savings incentive matching plans for employees (SIMPLE plans), profit-sharing plans, and pension plans. Eligible charities were generally limited to public charities such as educational and religious organizations, hospitals, and museums; and excluded donor advised funds, supporting organizations, private (family) foundations, and charitable remainder trusts.

Initially, this provision was enacted as a temporary measure for two years to expire at the end of 2007. In October 2008 it was extended for another two years through 2009. In December 2010 it was extended again for two more years ending 2011. Lastly, in January 2013, the provision was extended retroactively to 2012 for two years ending 2013.

The retroactive nature of the last extension in 2013 created issues with those who were planning a charitable gift of IRA assets but were uncertain of the tax consequences throughout 2012. Accordingly, the 2013 extension included provisions that allowed a taxpayer to treat a January 2013 IRA transfer to charity as occurring in 2012.

> "If … a taxpayer is certain that they want to donate a portion of their IRA funds regardless of the rollover provision, they should do so by a direct-transfer in order to qualify under the provision if it is eventually extended for, or made permanent in, 2014."

As of the writing of this article, the charitable IRA rollover provision has yet to be extended past 2013. The House of Representatives passed the *America Gives More Act* (H.R. 4719) in July 2014, which would make the IRA rollover permanent. The Senate Finance

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Committee passed the *EXPIRE Act* (S.2260) in April 2014, which extends the IRA charitable rollover provision for two more years ending 2015.

One of the requirements of the IRA rollover provision is that funds be transferred directly from the IRA trustee to a charity. If, in this uncertain tax environment, a taxpayer is certain that they want to donate a portion of their IRA funds regardless of the rollover provision, they should do so by a direct-transfer in order to qualify under the provision if it is eventually extended for, or made permanent in, 2014. If the provision is not extended or made permanent, the direct-transfer would be treated as if the transfer went to the taxpayer who then made a charitable gift of the amount transferred. Although the taxpayer would recognize ordinary income, it could be offset by an itemized charitable deduction.

Gift of Charitable Remainder Trust and Gift Annuity Income Interest

You may not need the income from your charitable remainder trust or gift annuity, or you would like to see your charity receive the benefit today. If so, you can make a "gift" of the future payments you are entitled to receive from these deferred plans. The value of this gift is the present value of the future payments that would have been received (income interest), calculated in accordance with IRS guidelines and based, in part, on the monthly IRS discount rate. With the IRS discount rates at historically low levels (2.2%), you could receive a charitable income tax deduction exceeding just about anything offered in the past.

The following assumes that there is no provision in the trust agreement, gift annuity contract, or local state law that prohibits the gifting of the right to the future payments. If the charitable deduction is greater than $500, IRS form 8283 must be completed. If the charitable deduction is greater than $5,000, a qualified appraisal is also required. We can provide the present value calculations and any appraisal that may be required for these types of gifts.

Charitable Remainder Unitrust

The present value of the income interest in a charitable reminder unitrust paying a 75 year-old life income beneficiary 5% of the trust's value annually, is about 40% of the trust's current market value. This income interest present value increases to about 60% of the trust's market value when the same life beneficiary receives 10% annually. The charitable deduction for a gift of a charitable remainder unitrust income interest is this income interest present value. Unlike gifts of income interests from charitable remainder annuity trusts and gift annuities, there are no additional calculations or limitations involved.

Charitable Remainder Annuity Trust

The present value calculation of an income interest in a charitable remainder annuity trust is slightly more complicated. If the payout rate of the annuity trust is greater than the IRS discount rate (currently 2.2%), the income interest present value calculation includes a *probability of exhaustion* special factor adjustment. The present value of the income interest in a charitable reminder annuity trust paying a 75 year-old life income beneficiary is about 9½ times the annual annuity amount. The charitable deduction is limited to the current market value of the annuity trust assets which could be significant if the annuity trust has been declining in value since it was created.

Gift Annuity

Although the present value of the income interest in a gift annuity is calculated in a manner similar to that of a charitable remainder annuity trust (without the *probability of exhaustion* adjustment), the determination of the charitable deduction is more involved. Since the obligation to pay the annuity is a general obligation of the issuing charity, there is no trust market value limitation on the charitable deduction. However, most believe that the charitable deduction is limited to the *undistributed investment in contract*, which is the initial (gift date) present value of the annuity minus all tax-free return, and any capital gain income, recognized by the beneficiary (1099-R tax form) in prior years. If all of your payments from a gift annuity are currently characterized as ordinary income (no tax-free return or capital gain) then there will probably be no charitable deduction available for the gift of your future annuity payments even though something of value has been given to charity (release from obligation to make future payments).

Determining the Date of a Charitable Gift

When making yearend charitable contributions, remember to keep the following general timing rules in mind:

- The gift date of a charitable donation in the form of a check is the later of (1) the date on the check and (2) the date the check is placed in the mail, or hand delivered, to the charity.
- Donations by credit card are dated as of the date of the credit card charge and not when the donor pays the credit card bill.
- Gifts of securities are dated as of the date the stock certificate, and related stock power, are received by the charity when hand-delivered or the date both are placed in the mail. The gift date is also the date the securities are electronically transferred to the charity via the *Depository Trust Company* (DTC) or the date the securities are reissued in the name of the charity.
- Mutual funds are gifted on the date they are transferred by book entry from the donor's brokerage account to the charity's account.
- Real property (land and buildings) is gifted when the charity receives a properly executed deed unless local law requires that the deed be recorded. When recording is required, the gift date is the date the deed is recorded. Personal property is deemed gifted when legal title is transferred to the charity and the charity takes *actual physical possession* of the property. ◆

Application of the 3.8% Medicare Tax on Investment Income to Distributions from Charitable Remainder Trusts and Gift Annuities

By Ken Dike, Esq., CPA, CLPF

The *Health Care and Education Reconciliation Act of 2010*, which amended the *Affordable Care Act*, created a 3.8% tax on net investment income received after 2012, including capital gains, for individuals with AGIs over $200,000 and those filing joint returns with an AGI exceeding $250,000. The application of this surtax to the distributions paid by charitable remainder trusts (CRTs) and gift annuities was a source of confusion throughout most of 2013 with the final regulations not published until December, 2013. If you received a 2013 K-1 from a CRT, it probably arrived much later than usual due to the required revisions of the underlying tax form 5227 that was not finalized until the end of February 2014.

Charitable Remainder Trusts

Beneficiary distributions from a CRT are characterized as (1) ordinary income, (2) short-term gain, (3) long-term gain, or (4) nontaxable income and return of corpus. The total available in the first tier (undistributed ordinary income at the beginning of the year plus ordinary income received during the year) is distributed in its entirety before any tier 2 (short-term gains) are distributed. The process follows through to the 4th tier, where any remaining distributions are characterized as nontaxable income or return of corpus. This process is further complicated by the 3.8% surtax since it only applies to investment income received after 2012, resulting in two more tiers (pre-2013 and post-2012 investment income) within *each* of the first three tiers.

As expected, the post-2012 investment income is deemed distributed to the beneficiary prior to any of the pre-2013 investment income. The following schedule illustrates this ordering:

	Available to Distribute			**Character of Distributions** (by total paid)			
	12/31/2012	2013	Total	$30	$75	$150	$200
Ordinary Income							
Post-2012 (3.8% surtax)		$20	$20	$20	$20	$20	$20
Pre-2013	$15		$15	$10	$15	$15	$15
Short-Term Gains							
Post-2012 (3.8% surtax)		$30	$30		$30	$30	$30
Pre-2013	$25		$25		$10	$25	$25
Long-Term Gains							
Post-2012 (3.8% surtax)		$40	$40			$40	$40
Pre-2013	$35		$35			$20	$35
Nontaxable and Corpus							$35

Gift Annuities

Payments from gift annuities are characterized as (1) ordinary income, (2) nontaxable *return of the annuity contract* or (3) long-term gain. The amount reported in each of the categories is determined by the life expectancy of the beneficiary and whether appreciated securities were gifted in exchange for the annuity contract.

Although the argument was made to the IRS that pre-2013 gift annuities paid only pre-2013 investment income (ordinary income and long-term gain), the IRS ruled that any ordinary income or long-term gain from any gift annuity that was paid after 2012, was post-2012 investment income subject to the 3.8% investment income surtax. ◆

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