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5 Critical Social Security Concepts You Need to Know to Elevate Your Credibility

Heather Schreiber, RICP®, Founder and President, HLS Retirement Consulting, LLC

Editor's note: This article is an adaptation of the live webinar delivered by Heather L. Schriber, RICP®, in 2022. Her comments have been edited for clarity and length.

You can read the summary article here as part of the 1st Qtr 2022 Retirement InSight and Trends Newsletter, worth 1.0 CE when read in its entirety (after passing the online quiz.)

You may also choose to take the full length course 5 Critical Social Security Concepts You Need to Know to Elevate Your Credibility for 1.0 hour continuing education (CE) credit.

By Heather L. Schreiber, RICP®, HLS Retirement Consulting, LLC

Social Security is a topic that is near and dear to my heart, primarily because I run into consumers and financial professionals every day that just are confused, and rightfully so.

In this article, we'll cover:

1. The steps behind the Social Security primary insurance benefits formula and why it is crucial for near retirees to understand it. This is probably the most technical I'll get, but it is important, and I will cover why.
2. The differences between deemed filing and restricted filing. The Bipartisan Budget Act of 2015 made some significant changes to some claiming strategies and took one of those strategies away. What are the strategies to now consider, and what exactly does deemed filing mean?
3. How to respond effectively to the breakeven question. How many of you work with clients and prospects who say, "Well, how long do I have to live for it to make sense for me to wait? I think I should just take it now." We'll cover how you have a meaningful conversation surrounding breakeven depending upon the dynamic of the individuals and couples with whom you work.
4. Why working and filing for benefits may not mesh on various levels.
5. How to instantly elevate your credibility with an often-overlooked strategy that has to do with pairing survivor benefits with one's retirement benefit that the Social Security Administration will likely not tell a widow or widower.
6. And finally, we will talk about how to effectively weave Social Security into the planning process that you are already doing well. You do not have to be a Social Security expert, but people always ask me, "What are the things that I need to know to set myself apart?"

What is the Primary Insurance Amount (PIA) Formula?

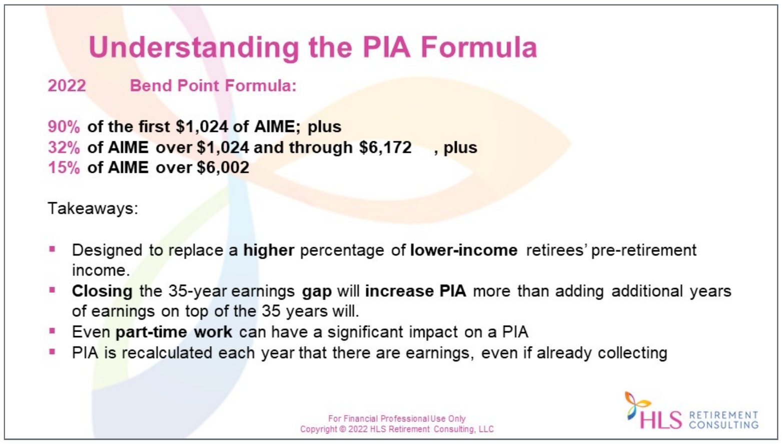
Many of you may already know from your studies or reading that the PIA is the benefit that someone would receive at their full retirement age. On the Social Security statement are three different projected benefit estimates. One is at age 62 because that is the earliest age to claim a retirement benefit. The full retirement age benefit, which can differ depending upon the year of birth, can be anywhere between ages 66 and 67. It is the primary insurance amount and is 100 percent of the earned benefit. The benefit is based on a formula, and it is based on a process of steps.

First, Social Security looks at all years up to the age of 59 with Social Security covered earnings, and they index those earnings to today's dollars. (Note: A client might have earnings that are not Social Security covered. Think about teacher, police, or fire retirement systems; in particular states that do not pay into Social Security. They have an equivalent system outside of Social Security that they pay into for retirement.) Why do they do that? Earnings from 1977 will not look nearly as wonderful as today's earnings, so they index those through age 59. The earnings that someone earns at age 60 or beyond are taken at face value.

Step number two is to calculate your primary insurance amount based on your highest 35 years of index-adjusted earnings. If someone has less than 35 years of earnings, Social Security does not say, "Well, you have 20 years. Okay, that is what we will base the formula on." They take those 20 years of indexed earnings and add 15 big fat zeros to the calculation. Suppose you talk to a client who wants to boost their primary insurance amount, and they don't have 35 years of covered earnings.

In that case, any additional year that they can earn something – even part-time work – and replace a zero will positively impact their PIA more than someone who has 35 years already and continues to work.

Step number three is after we have identified those 35 highest indexed years, you need to add that together, divide by 240, which is the number of months in 35 years. That is called the "average indexed monthly earnings" or AIME. Once we have done that, you apply that to the three-part bend point formula to calculate one's Social Security benefit. The point of this example is to show you how that benefit formula is calculated with higher AIMEs.



You will see that 90% of the first $1,024 of AIME is replaced for someone turning 62 this year. The income replacement goes down to 32 percent for the second tier and is reduced to 15 percent in the third tier, or bend point. Why is this important to know? You have heard that Social Security is not designed to replace all our pre-retirement income; it is designed to replace, on average, 40 percent. You will see that the lower someone's AIME is, the higher their replacement ratio is. Social Security is designed to replace a higher amount percentage-wise of a lower-earning person's income. This is important to understanding the bend point formula.

Closing the 35-year earnings gap will increase PIA more than adding additional years of earnings on top of the 35-years that someone already has. Some conversations need to be had about continuing to work. I do not care if someone already has 40 years of earnings. Anytime someone can report earnings, PIA is automatically recalculated, even if they already receive their benefit. Suppose someone filed for benefits at age 64 and continued to work in a second career. Social Security will recalculate that PIA formula if that most recent year of earnings replaces an earlier year in the 35, which had lower earnings. Then they could see an uptick in their benefit amount going forward the following January, along with the cost-of-living adjustment.

Going back to the bend point formula, be aware of dealing with someone who has non-covered earnings. Say you have a teacher, a civil service retirement system employee, or a federal employee. There Social Security statement will show zeros in the Social Security earnings column, but it will have income in the Medicare column. That tells you that they have non-covered income. When Social Security calculates their PIA, it will appear as though they are a low-wage earner because they have a bunch of zeros in that 35-year formula.

We have something called the Windfall Elimination Provision (WEP) that offsets or adjusts their PIA, or the amount they can collect from Social Security, to reflect that they are not lower-wage earners, but they worked in an alternate system. I am sure you have worked with teachers that say, "Wait a minute. I worked enough under Social Security to collect a benefit. My benefit estimate says I will get $1,000 a month from that work. I am getting this pension of $3,000 based on earnings. Why am I not getting my full $1,000 from Social Security?" They appear in the PIA formula to be a low-wage earner with 35 years in the alternate system reflecting zeros in earnings. Their AIME is going to be small. Their Social Security statement will show their income being replaced at 90 percent in that first tier, and it really should not.

The WEP reduces that first tier to as low as 40 percent, depending upon how many years of substantial earnings they have under Social Security. These workers are not being cheated per se; it is an equalization of benefits for working in an alternate system.

It is important to understand this if someone says, "Gosh. Is it worth it for me to work part-time?" especially if they have less than 35 years. Again, even part-time work replaces zeros, and it will increase their primary insurance amount. Again, the PIA is recalculated each year there are earnings, even if someone is already collecting. We tend to have our highest years later in our careers. Even though our earlier career earnings will be indexed, our most recent years could increase the PIA. The claimant could experience an increase, in addition to the cost-of-living adjustment, the following January.

Deemed Filing

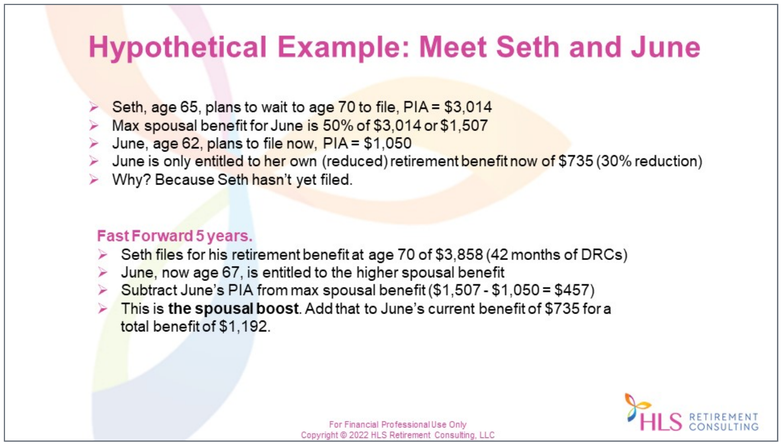
Anyone born after January 1st, 1954, cannot select which benefit to take between a spouse, ex-spousal, or retirement benefit. They are going to get the highest benefit to which they are entitled. If we have a low or non-earning spouse, they are still entitled to a spousal benefit once the wage earner files. They will get the higher of the two.

If there is any retirement benefit that this person has earned, that will always be paid first. Always. If there is a residual amount to be had by way of the spousal benefit, it is added on top of the earner's benefit to make up the difference for that higher benefit. What is the downside? I will only collect a spousal or ex-spousal benefit if it is greater than my own if I fall into this deemed filing category.

For example, suppose my benefit is roughly $1,600 a month based on my earnings at full retirement age. In that case, the chances are unlikely that I will get a spousal benefit because the maximum benefit at full retirement age for a worker who worked at the highest taxable wage base every year right now is $3,345 in 2022. Half of that for a spousal benefit is $1,650 and some change. If you are working with someone who says, “Well, my benefit is $1,700, $1,800, or $2,000,” they will not get a spousal benefit or ex-spousal benefit.

What if their benefit is $1,000 at full retirement age and their spouse has a $3,000 PIA? When they file at full retirement age, they will collect the $1,000 under their record, and they are going to get a step up to the higher $1,500 (one-half of the spouse’s benefit) by getting an additional $500 of that spousal benefit. Remember that the wage earner must file for their benefit for the benefit to be paid as a spouse. That means that entitlement may not always be simultaneous. For example, if I want to file now, but my higher wage-earning spouse does not want to file until later, I can file for mine, but I will not get the spousal benefit until he files. It is not always simultaneous.

Let’s suppose I file for my benefit at age 62. Fast forward five years from now, and my spouse has filed. I will not get the full 50 percent spousal benefit because I initially filed for my benefit at age 62. It is a bit more complex than that, but many advisors think, “Well, now they are at full retirement age, so they should step up to the full 50 percent.” They would not get the entire 50 percent if they filed for their benefit early.



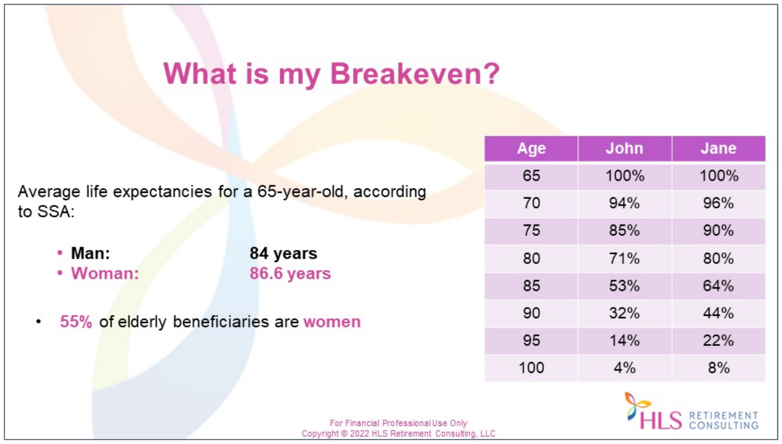
Let’s look at Seth, who is age 65. He plans to wait until age 70 to file, which is a wise decision because, as you can see, his primary insurance amount is high at $3,014. We know that the max spousal benefit for his wife, June, is $1,507 a month (50 percent of $3,104) if she waits until her full retirement age to collect it. June is age 62. She plans to file now, and her PIA is $1,050 at full retirement age so she will be claiming her benefit early. Remember that Seth has not filed yet, so she is only entitled to her benefit right now. So, she says, “Okay, I will take mine now with a 30 percent reduction because my full retirement age is 67.” Instead of June getting $1,050 a month, she will get $735. Remember, she is not entitled to Seth’s yet because he has not yet filed.

Fast forward five years. Seth is now 70. He has decided to file for his benefit. It was a very good choice for him because by waiting, he earned 42 months of delayed retirement credits, and his benefit is now $3,858 (this was with no COLAs). Now June is age 67. She is now entitled to the higher spousal benefit because the moment he files, she contacts Social Security. She should say, “I need my benefit reexamined because I am entitled to a higher benefit.” To figure out how much of the maximum $1,507 spousal benefit (one-half of Seth’s benefit at his full retirement age) she will collect, you first have to figure out the difference between the maximum spousal benefit and her benefit at full retirement age. So, the $1,507 maximum spousal benefit minus her maximum worker benefit of $1,050 at her full retirement age is $457. This is called the spousal excess amount or the spousal boost. That is the amount added to her current monthly benefit of $735. She can receive $1,192 in benefits per month by adding these two together.

This is one thing that I get more questions about and more flubs in what people tell their clients. It’s not, “Well, you are age 67 now, and you will automatically step up to the full 50 percent.” The critical thing they miss is that her spousal benefit will not equal half her spouse’s benefits because she claimed her benefit early. That spousal boost will be added to her already reduced retirement benefit. This is important to know when you are talking to clients.

What is My Breakeven?

It is the age-old question: what is my breakeven age? It is understandable why people want to know, “How long do I have to live to make sense for me to hold out for a bigger benefit?” This becomes an issue in particular for married couples.



Age	John	Jane
65	100%	100%
70	94%	96%
75	85%	90%
80	71%	80%
85	53%	64%
90	32%	44%
95	14%	22%
100	4%	8%

According to Social Security, the average life expectancy for a 65-year-old male is age 84, and for women, it's almost age 87. We have brand new life expectancy tables for required minimum distributions (RMDs) that start this year that reflect we have had increasing longevity for a while. Fifty-five percent of elderly beneficiaries are women and no surprise that three out of four women are widowed by the time they are 75.

Breakeven is an easier conversation to have when dealing with a single person because the only person they are trying to make income last for is themselves. But when you are dealing with a couple, particularly when you have a marked disparity in their income benefits, it is a question that needs a little bit more consideration.

The information above is from a website called longevityillustrator.org. The example shows life expectancies for John and Jane, both born on the same day, in average health, and both are non-smokers. The chart shows the likelihood of them living to an advanced age. There is a 44 percent chance that Jane will live to age 90, and John has a 32 percent chance. It is important to look beyond average longevity when dealing with the couple as a unit. It changes the conversation. You must make sure that the decision they make for claiming is the best decision for both of them.

We all tend to underestimate how long we will live, and the amount of time we will spend in retirement, proven by numerous studies. The reality is that longevity is increasing, and life expectancy is increasing. Women tend to suffer financially after their spouse dies. And they rely more heavily on Social Security for a variety of reasons. They are less likely to have access to a pension. They may have left the workplace or never worked outside the home to help raise a family. They might be helping take care of a parent. We tend to take those roles on more than our male counterparts. We have less in savings and retirements savings. We have a lower primary insurance amount.

This is why it is important to think about the breakeven analysis in terms of the couple, particularly if we are dealing with a couple with a lower benefit than the other. When one spouse is the high-wage earner, when that person files, it is the gift that can keep on giving or not. When I am looking at a case and seeing a marked disparity in benefits, I home in on that. I am saying, "Okay, higher wage earner, we need to focus on when you file because when you file, it will affect not only lifetime income while you are both living and enjoying life, but it will affect the survivor. Whether that is you, or whether that is your spouse."

Consumers do not fully understand what happens when one of the spouses dies concerning Social Security. They do not understand that the lower of the two benefits disappear. We are dealing with a reduction in income. The difference between the higher wage earner filing at age 62 versus even full retirement age can significantly impact that surviving spouse's income. People ask me all the time for a rule of thumb. I run from the rule of thumbs, particularly with respect to this, because so much goes into what is the right decision for individuals and couples. However, when working with a couple with an income disparity, I do not mind allowing that person to file early because they are the lower-wage earner. If I can talk to the higher wage earner and ask, "Is there any way that we could have you hold out a little bit longer so that we can secure a higher replacement income from Social Security, so we put less of a burden on your other assets while you are both living? This is then some insurance for the surviving spouse to have a higher replacement ratio of income when one of the two of you passes."

This is really my only rule of thumb. I disagree that everyone should file at age 62 because it will all go defunct or that everyone should file at age 70, and that is just not reality. You are there to have thoughtful conversations about how much they have saved for retirement, their goals, and what they want to do in retirement. Those are all things that do go into this claiming decision.

Working and Claiming a Benefit

What if someone wants to claim their benefit early and still work? Social Security limits how much someone can earn while collecting benefits. I get questions like, "Does my IRA distribution count?" No. It is not earned income. If you are working with someone who plans to file early for Social Security and they are working, then there is a chance that their benefits could be withheld, or they may not even be able to file for benefits. Suppose someone is between age 62 and the year before they hit their full retirement age in 2022, and they earn more than $19,560 while receiving Social Security benefits. In that case, excess income over that amount will cause their benefits to be withheld by 50 percent of that excess. The earnings limit only applies until a claimant reaches FRA. I believe in getting people to their full retirement age so they do not have to worry about having benefits withheld and possibly not paying taxes on their benefits.

What does not count as earnings? Unemployment compensation does not count. Pension income does not count. These are all passive sources. Rental property income. IRA distributions. Alimony for settlements entered into after 2018. Or a spouse's earnings. If they say, "Well, I am retiring, but my spouse is still working. I am the one that wants to claim early." Technically, they can claim early. Should they? That is another conversation because they are likely to pay taxes on a portion of their benefit because of their spouse's earnings.

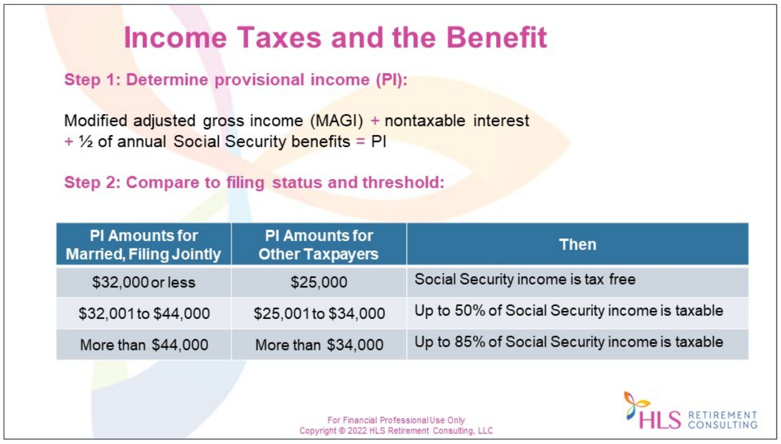
Let's look at income taxes and the benefit. There is a two-step process to determine whether any benefits are subject to tax. The first step is determining provisional income (PI), sometimes called combined income. It is a function of three things:

1. Modified adjusted gross income (modified just simply means we are not including Social Security in the income because we are not going to include it twice), plus
2. Non-taxable interest, such as municipal bond interest that we know is federally income tax-free, plus
3. Half of the annual Social Security benefits received.

Unlike the earnings limits that only look at the filer's earnings, potential taxation of Social Security benefits also looks at the earnings and the benefits of the household. Say two spouses are collecting benefits.

1. Total their annual benefits and divide by two to determine their provisional income.
2. Compare that number to their filing status and threshold. (These taxes were added in the 1983 Act for Social Security, and they have never changed.)

They might pay taxes on up to 85 percent of their Social Security benefits.



If a married couple has a provisional income of $32,000 or less, they do not have to worry. These folks are living probably squarely on Social Security and not much more. If they are anywhere between $32,000 to $44,000, 50 percent of their benefits must be pulled in as a line item to be federally taxed. If their provisional income is over $44,000, then as much as 85 percent can be taxed.

Pensions are considered taxable income. Which sources of income could they have that would not hit the bottom line? Qualified Roth distributions are a good one. We should be talking about Roth conversions before we claim Social Security. Income from permanent life insurance is not included in this calculation.

What are some common points of confusion concerning taxes? The earnings limit and taxation of benefits are two separate sets of rules. I get many questions about the earnings limit and taxes, and they seem to get interchanged. The earnings of a spouse and all other sources of income are included in determining whether the benefit or a portion of it is subject to taxes, whereas, if we compare this to the earnings test, it is only earned income and only that of the early filer. For taxes, everything is fair game. All sources of taxable income are included, not just earned income. The potential for taxes to apply to a benefit does not disappear at full retirement age as the earnings limit does. You must be aware of municipal bond interest if you work with folks with this in their portfolio, as it has to be included in calculating taxation on Social Security benefits.

Survivor Benefits

Age 62 is a critical age. It is the earliest age at which someone can collect a Social Security retirement benefit. That is also the earliest age when someone, a spouse or ex-spouse, can collect a spousal benefit. For survivor benefits, it is a little bit different. The earliest age that a widow or widower can claim a survivor benefit is generally age 60 or older. It could be as early as age 50 if the survivor were disabled within seven years of the death of their spouse. Another way a survivor might receive benefits before age 60 is for a child-in-care benefit. If the survivor has a child-in-care of the deceased under age 16, they might get a child-in-care benefit until the oldest child turns 16. Or they might get a child-in-care benefit if they are caring for a child of the deceased that was disabled before the age of 22.

You must be married for at least nine months to collect an aged widow or widower benefit at age 60. You will need to be married for one year to file for spousal benefits for someone still living. Ex-spousal survivors can also collect a benefit if they were married for at least ten years. If you remarry while your former spouse is living while collecting ex-spousal benefits, those benefits stop. But in the case of ex-spousal survivor benefits or even aged widow or widower benefits, an ex-spouse survivor can remarry at age 60 or later and still collect a survivor benefit as long as they were married for more than ten years. A widow married for at least nine months when their spouse dies can remarry at age 60 or later and still collect a survivor benefit. What? People miss this. By not remarrying until age 60 or later, that (ex-)spouse down the road will still be able to collect that widow or widower's benefit.

How much can they collect? With spousal and ex-spousal benefits while that other spouse is living, it is a maximum of 50 percent of the worker's primary insurance amount. When we are dealing with survivor benefits, it goes up to a maximum of 100 percent of what the deceased spouse was collecting at the time of their death or entitled to collect at their death. Let's suppose we have a person aged 60 or even age 62 that passes before they ever collect it. That means their survivor base amount is calculated as if they had reached their full retirement age when they died. That is a common question. In other words, the widow or widower is not penalized because the deceased had not yet collected; that survivor benefit is calculated as if the deceased had reached full retirement age.

What if they plan to file at age 70 and die early at age 68? This also benefits the survivor. The base amount is calculated as if they died and claimed on the day of death. The two-year delayed retirement credits are passed on to the survivor's base amount. Note that there is a maximum of 100 percent of the deceased's benefit. Like any other Social Security benefit collected early, the aged widow or widower benefits are reduced based upon the number of months they file early. They can file at age 60, but they will not get 100 percent of the benefit.

The child-in-care benefit could be at any age for a surviving spouse taking care of the dependents of the deceased. That benefit maximum is 75 percent and not reduced unless the family maximum reduces it. Only the aged widow or widower benefits are reduced. There is also a whopping $255 lump-sum death benefit paid to the surviving spouse. It would be paid automatically only if the spouse was already collecting spousal benefits under that person. If they were not, the surviving spouse would have to file form SSA-8 to get those benefits. I know it is not a lot, but people miss it because they don't file for it.

What is an effective technique that everyone misses? I call it the survivor switch technique. If someone is entitled to both a survivor benefit and their own retirement benefit, they can restrict their filing to one or the other. Now, restricted filing where both spouses are alive or the ex-spouse is alive can only be used for people born before January 1st, 1954. This does not apply to survivor benefits, and people miss it every day. If you are entitled to both a survivor benefit and your own retirement benefit, you need to figure out which benefit will be the higher of the two in the long run. First, file for the smaller benefit and later switch to the higher benefit to give me the highest lifelong income benefit for the rest of my life.

In terms of restricting from one to the other, survivor benefits are not subject to that same January 1st, 1954, birthdate requirement. That only applies to living spouses and ex-spouses. This is singly one of the most often overlooked opportunities that I help people with every day. Be aware. Social Security might assume that because the survivor benefit will be higher, you will file for all of them simultaneously. You will lose the opportunity to file for the smaller one first and hold out of the higher one later because they are not told you can do so.

Let's look at an example. Janet turned 66 last July, and her husband passed recently. He was collecting $2,100 a month at the time of his death. This is the survivor base amount. Susan has not yet filed for her benefits. Her estimated benefit at her full retirement age is $1,800. What are her options? If she contacts Social Security, they might say, "The $2,100 is higher, so just go ahead and file for that." Technically, this is a deemed filing. They assume, "Let us just put all of your tickets in the hat for both retirement and survivor income. We will pay the $1,800 for your benefit, and then we will pay you that survivor boost of $300 to bring you to the higher total of $2,100." That makes sense, and Janet probably would not question that, would she?

The second option would be, "Okay, wait a minute. I know that there is something I can do here. I am going to restrict my filing to survivor benefits now. And I will wait until age 70 to file for my own." Why would I do that? Janet could collect $2,100 now as she is now at full retirement age for 100 percent of that survivor base amount. She will hold out to file for her own benefit because, at that point, that $1,800 has become $2,352 because she has earned 46 months of delayed retirement credits by waiting. This is the difference and what people are not told when they contact Social Security. Social Security is expressly prohibited from giving anything that looks like advice, so they will not be told this. This is where you can look like a hero and help them leverage income. It works both ways.

What if survivor benefit is going to be higher forever? There is no way that at age 70, her own retirement benefit will be higher. In this case, she would take the $2,100 and go for the rest of her life because her own benefit would not be higher. However, let us suppose she is 62, and her own reduced benefit is $1,000 a month. She might then want to file for her reduced retirement benefit and hold out until full retirement age, so she gets 100 percent of that survivor benefit. This strategy can work either way. Advisors need to be very mindful of this when working with widows and widowers.

Here are some things to remember. Survivor benefits, just like any other benefit claimed before full retirement age, are subject to the annual earnings test. There might be situations where Social Security says you make too much money, come back when you do not or when you hit full retirement age, whichever occurs first. Suppose the survivor benefit is collected before the survivor's full retirement age. In that case, it will be reduced based upon the number of months before FRA it is claimed, just like any other benefit. Social Security will generally not tell you this. I find, and there are some wonderful people at the Administration, that the old-timers are starting to retire. The new ones have come on during COVID, and they are challenged to even know that these techniques exist. Your clients have to file for benefits empowered with information to know that they can even do this.

How do you figure out which one to file for first? You want to compare the survivor benefit at the survivor's full retirement age to the maximum of their own retirement benefit at age 70. Whichever one is higher, you file for the lower one first. Do not miss this. This is a tremendous opportunity for you to bring value to your clients.

Key Takeaways

1. The decision on when to claim Social Security cannot be made without looking at a near retiree's entire retirement income picture. This is where you have such value because for them to say, "When should I file?" Well, you know what, Mr. and Mrs. Smith, I need to know more about you. What other sources of income do you have? What type of income is that? How is it going to be taxed in retirement? Because we do need to think about the tax part of it. Who is going to work and until when? How much? Is there a chance you could go back and have an encore career? All these things come into it.

2. The other things that come into it are very much the emotional part. "I have worked hard for this; I should be able to file. Is there a way we can do that?" Hopefully, we can get some of the Social Security income into the household by the lower wage earner and hold out for the higher one later. There is no one size fits all approach. We also deal with people, emotions, needs, and income needs. Using rules of thumb such as everyone should start at age 62 or wait until age 70 does not apply and takes away the value you provide.

3. Be proactive by asking many questions to uncover opportunities to leverage more significant benefits. If there is a survivor situation or a wide disparity in ages, ask if they have any kids and how old are they. If the kids are under the age of 18 or still in high school and not older than age 19, the 65-year-old spouse filing can now open the opportunity to collect dependent benefits for those children.

4. When working with married couples, special attention should always be given to the higher wage earners filing age when dealing with a marked disparity in income benefits. We want to focus on getting that higher wage earner to hopefully wait until full retirement age or longer if they have other sources of income or continue to work. This will build more income from Social Security while they live and leave the surviving spouse with more replacement income from Social Security survivor income.

5 Critical Social Security Concepts You Need to Know to Elevate Your Credibility

About Heather L. Schreiber, RICP®, Founder and President, HLS Retirement Consulting, LLC, Retirement Income Strategist, Speaker, Writer, and Trainer to Financial Professionals

Heather Schreiber, RICP®, is Founder and President of **HLS Retirement Consulting, LLC**, Heather partners with financial, legal, and tax professionals to build holistic client solutions for retirement.

Heather prides herself in her ability to customize potential solutions to meet the needs of each client or prospect as well as her ability to turn complex strategies into easy to understand terms. In her 20th year in the industry, Heather has worked within the finest organizations including Franklin Templeton Group of Funds, AXA Advisors, SunTrust Bank and one of the largest FMOs in the country. She is frequently asked to speak at industry events, radio programs, recruiting webinars and created and led a series of bi-annual 2 ½ day intensive training events for elite advisors on effectively weaving Social Security planning into their sales process.

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Determining Your Client's Retirement Income Style

Wade D. Pfau, Ph.D., CFA, Professor of Retirement Income for the American College of Financial Services

Editor's note: This article is an adaptation of the live webinar delivered by Wade Pfau in 2022. His comments have been edited for clarity and length.

You can read the summary article here as part of the 1st Qtr 2022 Retirement InSight and Trends Newsletter, worth 1.0 CE when read in its entirety (after passing the online quiz.)

You may also choose to take the full length course "Determining Your Client's Retirement Income Style for 1.0 hour continuing education (CE) credit.

Click here to find Wade's new book, Retirement Planning Guidebook: Navigating the Important Decisions for Retirement Success (The Retirement Researcher's Guide).

By Wade D. Pfau, Ph.D., CFA, Professor of Retirement Income for the American College of Financial Services

Alex Murgia, Ph.D., and I conducted this research in 2021 to help us understand when different retirement strategies best apply to different individuals. This is an ongoing debate in the profession. Today I saw an online discussion board where two people argued about the superior approach: time segmentation or total returns investing. At the end of the day, the premise of what I will be talking about today is that they are both viable approaches. It is just a matter of understanding when one particular approach might appeal to particular clients and when the other might appeal to particular clients.

We'll specifically look at how to:

1. Better understand client preferences and how that can define the existing retirement strategies that we know about.
2. Identify various approaches taken for retirement income
3. Explain underlying retirement income factors, which can then explain three retiree preferences that coalesce into a retirement income style,
4. Link retirement income styles to existing strategic approaches for retirement income that satisfy retiree preferences.

How is Investing for Retirement Income Different from Investing for Accumulation?

We have known for quite a long time that when you are investing for retirement distribution or taking distributions in retirement, it is different from the pre-retirement wealth accumulation phase. It is not just a matter of getting to the top of the mountain but safely getting back down the mountain in the face of the longevity risk, the sequence of returns risk, amplifying investment volatility, the spending shocks related to long-term care, and other events.

Retirees must think differently when spending from their assets versus when they are accumulating their assets. But it is still the Wild West in terms of strategy. You can ask the fundamental question, "What's the safe spending rate from an investment portfolio?" and get wildly different answers. The correct answer is to understand better when the different approaches might best apply to different types of clients.

Back in 2017, in one of my older books, "*How Much Can I Spend in Retirement,*" I made an effort to identify different retirement strategies available today. At that time, there were 37 different spending strategies. How can we start to position these different strategies with different individuals? The solution here is to assess retirement income style preferences. When a client starts to think about how they might want to approach building a retirement strategy, we can match these individuals' preferences to a method for sourcing their essential retirement income. How do they want to draw to cover their core retirement expenses? Are they comfortable using a total return investment portfolio, or would they prefer a different approach, whether time segmentation, income protection, or risk wrap? Once they have their floor covered, how can we better align their discretionary goals to an investment portfolio?

We have known for a long time that modern portfolio theory, the accumulation-based models that many financial planners use, were not designed for retirement. Even Harry Markowitz, the founder of Modern Portfolio Theory, has pointed this out after winning the Nobel Prize. He said, "I never really thought about investing for households. Modern Portfolio Theory was meant for large institutions", and households face many differences that coalesce into retirement. Modern Portfolio Theory was an assets-only model, and it is a single time-period model. How do you choose an asset allocation to affect the risk-adjusted returns over one time period if there is no distribution constraint if you are only trying to grow the pot of assets? The household's problem is different; they need to fund distributions over an unknown time horizon. In an article from 1991, Markowitz pointed out that just after winning the Nobel Prize, Modern Portfolio Theory wasn't designed to meet the household investing problem.

What are Today's Primary Retirement Income Strategies?

Now, as well, we have had different retirement strategies. There are four core strategies that we are trying to help guide clients towards understanding which one might be appropriate for them: total return investing, income protection, time segmentation, and risk wrap.

How do retirees choose a strategy? Now people might be listening to radio shows, and many financial advisers have radio shows where one show after the other might present completely contrasting retirement approaches. They might read personal finance blogs or follow the personal finance consumer media. They might attend a local seminar or a webinar or attend a local class. Many advisors will teach through the local community, college, or education programs for the Parks and Rec in their hometown a class on retirement planning. Or they might go directly to work with a financial advisor.

Increasingly, I think we will find advisors who will be more agnostic and may be able to offer different strategies. Right now, however, it is not a very efficient process. We have lacked the tools to identify who should use which strategies, and that is really what this research was meant to help provide such a tool to help match people to strategies.

Risk Tolerance Questionnaires

We have these during the accumulation phase, and it presupposes everyone is a total returns investor. It is based on Modern Portfolio Theory to identify which asset allocation a person is most comfortable with. This is the tool that gets used for pre-retirement planning. Ultimately, to the extent that people do not treat retirement as being different from accumulation, it continues to be used post-retirement. Risk tolerance questionnaires were born out of necessity and designed to provide advisors with something to document the suitability of an asset allocation strategy. However, it is only about short-term market volatility. With retirement, there will not be a single metric that people are trying to optimize. They are going to have different concerns, and they will place different importance on different concerns, whether they are worried about outliving their money in terms of their core retirement expenses, worried about missing out and not maximizing their overall lifestyle as much as possible, worried about not having liquidity to cover the unexpected long-term care and so forth in retirement. They also might be worried about legacy. (However, we found this is a less critical overall goal for people with our study.) Today's risk tolerance questionnaire wasn't designed to handle these other types of concerns.

So, retirement is different, and we need a tool to capture the differences. We need a more multidimensional assessment of the risks people face in retirement to understand better their concerns and what kind of strategy might better facilitate them. Concerns such as:

1. Are you concerned about longevity, or are you concerned about meeting your core retirement expenses over your whole lifetime?
2. What is your concern about lifestyle? This is the discretionary income goals. Are you concerned about not maximizing your overall spending and getting the most enjoyment out of retirement?
3. Are you concerned about meeting legacy goals and leaving something to the next generation?
4. Are you concerned about liquidity and having reserve assets available for the unexpected in retirement?

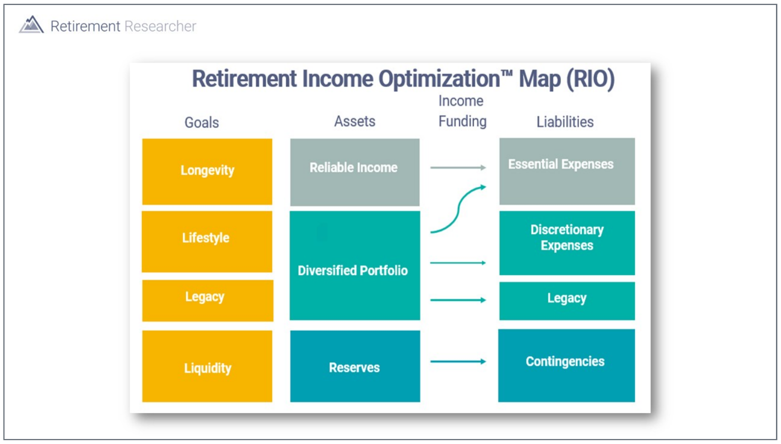
It can be hard to match up a style, but this is how we might be able to facilitate that conversation with clients by having a starting point for the conversation of the style that might best appeal to them.

Our research was based on a large literature review of reading and anything we could about retirement planning, designed for consumers, financial professionals, etc. What was being discussed? What were the factors that might impact people's decisions and that represented a range of potential attitudes? We ended up writing about 900 questions. This initial research phase was done through Retirement Researcher, my website. We had about 1,500 participants, many of whom are do-it-yourself retirees who treat personal finance as a hobby.

Two factors showed the most importance in explaining the style: probability-based versus safety first and optionality versus commitment. Four secondary factors (time-based vs. perpetuity income floors, accumulation vs. distribution, front-loading vs. back-loading retirement income, true vs. technical liquidity) were also important and relevant to understanding a person's preferences for retirement income.

The Retirement Income Style Awareness® (RISA) Leads to Specific Strategies

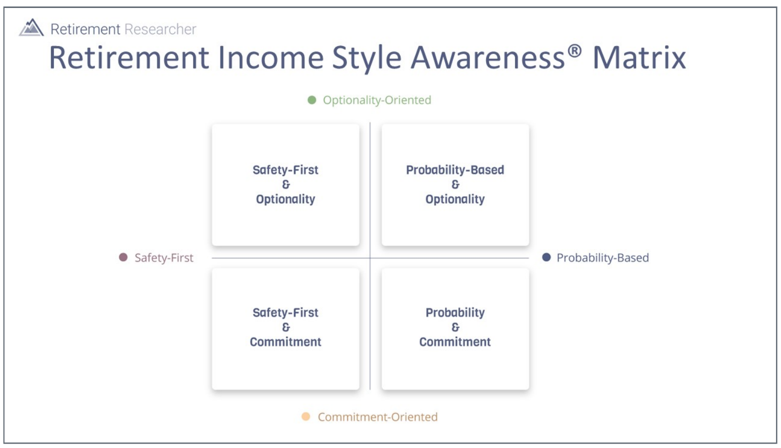
So, this is about building a financial plan for clients where the financial goals or those four Ls reflect those concerns, mapping the goals into the liabilities or expenses associated with those goals, and positioning assets to match the liabilities.



Assets are treated as reliable income assets (such as Social Security, pensions, annuities, individual bonds held to maturity, and so forth), the broader diversified investment portfolio, and then reserve assets (which are simply things not earmarked for other purposes that are available to help cover contingencies in retirement such as spending shocks and things that aren't budgeted into either essential or discretionary spending).

The Retirement Income Style Awareness® (RISA) profile is about understanding how people want to source their essential spending. Are they comfortable doing that with a diversified investment portfolio? Do they want to do that with individual bonds? Do they want to do that with some type of annuity product, whether it is an immediate annuity or a deferred annuity with a living benefit attached to it?

Our retirement income style approach is ultimately agnostic. We do not think any of the four general strategies are superior; we think they are all viable. It is really, "What are you comfortable with? Are you comfortable relying on the stock market, or are you comfortable having contractual protections?"



The first of the two primary retirement income style factors is probability-based versus safety first. How do you want to draw retirement income? How do you want to source your reliable income in retirement? If you are probability-based, you are comfortable depending on market growth. Depending on the risk premium, the idea is that stocks will outperform bonds over reasonable holding periods. Historically, that has been the case with the six percent risk premium we have seen with large-cap U.S. stocks over long-term U.S. government bonds going back to the 1920s.

If you are safety-first, you are not comfortable fully being dependent on the stock market to source your essential spending needs for retirement. You would prefer some sort of contractually driven income to have more safety. Of course, nothing is 100 percent safe, but relative to unknown market outcomes, having contractual protection implies a much higher degree of safety. That doesn't have to be an annuity because this could include holding individual bonds to maturity where you are contractually protected to receive the face value at maturity and coupons along the way. Risk pooling is a way to get additional yield on top of the individual bonds to have something that may be more competitive with the risk premium from the stock market. That is the idea of mortality credits with annuities; some of the premium from those who do not live as long helps to fund payments to those who live longer and then provides that contractual protection. If I am someone who ends up living a very long time in retirement, I know that I do not have to rely on the stock market to fund that. I have risk-pooling mortality credits to help fund that longer retirement for me.

The other primary factor is how much optionality do you want to have? If you prefer optionality, you emphasize flexibility. You want to keep your options open as much as possible. You want to take advantage of new opportunities or make major changes to your planning approach in the future. You do not want to get locked in or committed to anything; you want to keep things open as much as possible.

However, if you have a commitment orientation and can find a strategy that will solve your lifetime income need, you are comfortable committing to it. You may give up some of the flexibility of being able to make changes in the future, but that is okay. You know it is going to solve the problem for you.

With the RISA matrix, we map the probability-based safety first horizontally and the optionality commitment vertically to get four sets of characteristics. If you are in the upper right-hand corner, you are probability-based, have an optionality preference, and so on. The secondary factors are not required. The two primary factors can tell the story, but this can help refine the story about retirement styles.

Secondary factors include:

1. How do you view your reliable income floor? Do you have a time-based preference or a perpetuity-based preference? If you are time-based, you are not thinking about lifetime income.

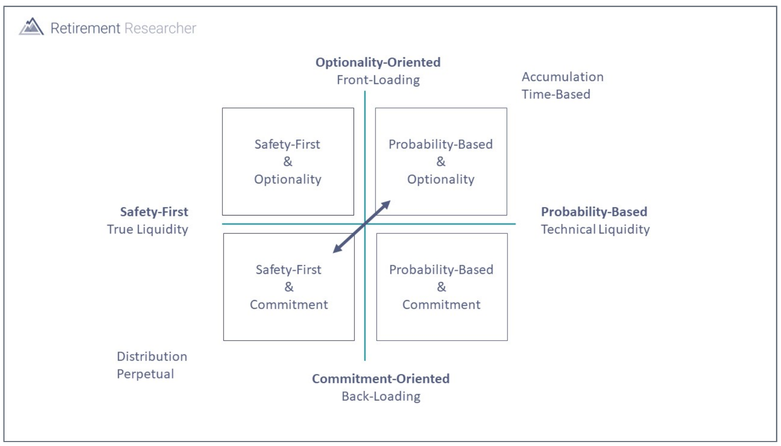
2. How do you view your reserve assets? Do you have a true liquidity mindset or a technical liquidity mindset? The technical liquidity mindset reflects that you are not earmarking assets for different purposes, and you define liquidity as the technical. A brokerage account is liquid. With true liquidity, you will not count an asset as liquid if it is earmarked for another purpose.

3. What's your mindset about retirement investing? Do you have an accumulation mindset or a distribution mindset? If you have an accumulation mindset, you effectively use the same pre-retirement approach post-retirement. You are emphasizing growth over predictable income. If you have more of a distribution mindset, you become more focused on supporting spending goals and emphasizing predictable income over maximizing growth.

4. How do you balance current versus future spending? Do you have a front-loading preference or a back-loading preference? If you have a front-loading preference, you are thinking about spending more today, maximizing the present lifestyle. Someone with a back-loading preference is comfortable sacrificing, not necessarily spending as much today because they have more concern that they might outlive their assets.

Natural Retirement Risk Correlations

Okay, so now we can add those characteristics into the chart and start talking about the natural correlations that happen.



In the upper right-hand quadrant is someone who is probability-based, so they are comfortable relying on the stock market and who has that optionality orientation. They want to preserve as much flexibility as possible. With the secondary characteristics, this is also somebody who also has more of a front-loading preference. They maintain that accumulation mindset. They are not as worried about having a predictable income to the extent they think about flooring. It is time-based, not perpetual. They also have more of a technical liquidity view of how they approach liquidity or total returns investing. That is the idea of building a well-diversified investment portfolio and taking systematic distributions from it throughout retirement. The starting point for all that conversation would be something like the four percent rule. It is how do you draw from an investment portfolio in retirement?

Now, this is one of the natural strategies, and this is where the existing strategies came out in such an interesting way. There tends to be a correlation. We think somewhere around a third of the population may exhibit this preference. We are completing a national study right now to confirm that further. Our existing studies are based on the Retirement Researcher community, not nationally representative of the U.S. population. Still, our preliminary results from doing a national survey at this point confirm that about a third of the population orient toward total return. Academics for a long time have known about this idea of the annuity puzzle, which is they cannot understand why people do not use annuities more. When you see the preferences that align in this total return quadrant, you understand why they do not want annuities. There is nothing here that suggests an annuity would help them. They are comfortable with the stock market. They do not want to commit to a strategy. They are more focused on enjoying their early retirement years. They are not thinking about predictable income, and they have that technical liquidity mindset and a time-based segmentation. They do not need an annuity.

The other natural correlation – that diagonal arrow is about moving from total returns in the upper right to income protection in the lower left – is the world of the simple income floor. These are people who value safety first, so they want contractual protections. They are comfortable committing to a strategy. They think in terms of a true liquidity mindset; they think in terms of distribution. They are focused on predictable income. They are thinking more about a perpetual income floor, not a time-based income floor. They also have a back-loading preference. They are more worried about protecting their future self and not having a significant cut later in retirement. These are the characteristics of using annuities to build a reliable income floor to meet your longevity expenses. Then you can invest on top of that for other discretionary types of goals. They do not want to be exposed to stock market risk to cover their basic retirement expenses. This is also a natural correlation because safety first correlates with a commitment orientation.

The other two strategies are less natural correlations, which also explains their evolution as more of a behavioral approach. This came up in a conversation I read recently on a discussion board, saying people need time segmentation because they are not comfortable with the total return strategy, and it is behavioral. They will panic and sell all their stocks after a market downturn, whereas time segmentation helps them stay the course of their strategy. Well, time segmentation people have inconsistent preferences. They want contractual protections, but they also want optionality, which are not natural correlations. If you sign a contract, it is hard to have options. So, time segmentation evolved to try to facilitate these preferences. You have the contractual protections by holding individual bonds to cover upcoming short-term expenses, and that is where you are getting that safety first feeling. But at the same time, you are maintaining optionality because you then have this growth portfolio. Your investments are meant to cover long-term expenses. You are relying on the idea of stocks for the long run. If I can leave my stocks alone for a few years, any sort of downturn should recover before I am forced to tap into those stocks. This is a behavioral story of how that can help people behaviorally stay the course. Not everyone, but if they have this type of time segmentation preference, they are also thinking more in terms of true liquidity and front-loading, so they are less concerned about outliving their money. This is what time segmentation is.

The other behavioral strategy is risk wrap. We have seen the evolution of deferred annuities with living benefits. People didn't always want to commit to annuitizing a contract and losing that contract's liquidity and upside potential. We see with risk wrap that these are individuals who are probability-based. They are comfortable relying on the market, but somehow, they do not 100 percent want to rely on it, so they have other preferences. They are also comfortable committing to a strategy. They do not need to have full optionality. They do also have this back-loading preference. They are worried about outliving their money more than a total return person. They also have a technical liquidity mindset, the same story as the liquidity of a deferred annuity. It is the same idea. This contract may be technically liquid, just like a brokerage account, but if you spend that money on something else, you will reduce the guarantee you receive. But you think more in terms of that technical liquidity.

About a third of the population does exhibit total return preferences. About a third are income protection. About a sixth of the population is time segmentation, and about a sixth of the population is risk wrap. After taking this questionnaire, individuals now have this starting point for a conversation about which strategy resonates with their preferences. We can help people identify where to have that starting conversation.

Key Takeaways

There are multiple viable approaches for retirement income. Total returns, time segmentation, income protection, and risk wrap are all viable strategies. It is just helping people understand when a particular strategy may resonate with them. The right approach for someone depends on their style.

A fundamental premise here is that all these strategies have good points, and it is then just a matter of finding the right approach for someone based on their style. These RISA factors can help identify a starting point for that strategy discussion. It is important for advisors to understand their own personal style, how it may impact their advice, and how to recognize whether their firm offerings align with the client's style. Do they understand that the client might have a different style than what the firm can provide? How are they working with that? Are they pigeonholing everyone into a total return investing strategy when it may only be that that type of approach will resonate with only about a third of the population?

My newest book was published in September 2021, if anyone is interested. (Retirement Planning Guidebook: Navigating the Important Decisions for Retirement Success.)

The first chapter does go into more detail about this retirement income style awareness, including a link if you would like to take the RISA for yourself.

Determining Your Client's Retirement Income Style – Wade Pfau

About Wade D. Pfau, Ph.D., CFA, Professor of Retirement Income for the American College of Financial Services

Wade D. Pfau, Ph.D., CFA, is a Professor of Retirement Income in the Ph.D. program for Financial and Retirement Planning at The American College in Brin Mawr, PA. He also serves as a Principal and Director for McLean Asset Management, helping to build retirement income solutions for clients, and Chief Planning Strategist of software provider inStream Solutions. He holds a doctorate in economics from Princeton University and publishes frequently in a wide variety of academic and practitioner research journals on topics related to retirement income.

Wade hosts the website and is a monthly columnist for Advisor Perspectives, a RetireMentor for MarketWatch, a contributor to Forbes, and an Expert Panelist for the Wall Street Journal. His research has been discussed in outlets including the print editions of The Economist, New York Times, Wall Street Journal, Time, Kiplinger's, and Money Magazine. He is the author of Reverse Mortgages: How to Use Reverse Mortgages to Secure Your Retirement and How Much Can I Spend in Retirement? A Guide to Investment-Based Retirement Income Strategies.

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Advance Planning for Clients with Health Savings Accounts (HSAs) and Medicare

Kelley Long, CPA/PFS, CFP®

Editor's note: This article is an adaptation of the live webinar delivered by Kelley Long in 2022. Her comments have been edited for clarity and length.

You can read the summary article here as part of the 1st Qtr 2022 Retirement InSight and Trends Newsletter, worth 1.0 CE when read in its entirety (after passing the online quiz.)

You may also choose to take the full length course Advance Planning for Clients with Health Savings Accounts (HSAs) and Medicare for 1.0 hour continuing education (CE) credit.

By Kelley Long, CPA/PFS, CFP®

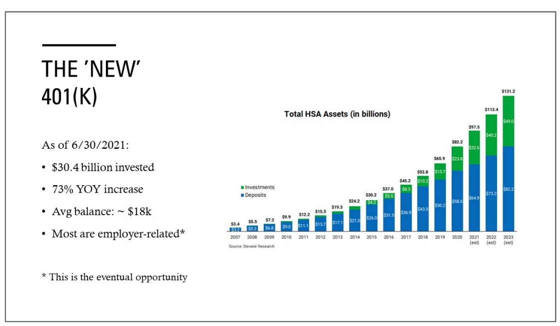
This article is about avoiding pitfalls when continuing to contribute to a health savings account (HSA) once you're receiving Medicare. There are a lot of Medicare rules that I have had to become familiar with; I do not want to put myself out as a consultant for when and how to enroll in Medicare, whether or not to defer it, and how to avoid those late enrollment penalties. I am just making sure that I am staying in my lane here as a health savings account expert and on the ancillary effects of Medicare enrollment.

We will go over some scenarios where clients might be at risk for penalties due to that late enrollment or, on the flip side, making ineligible contributions to health savings accounts and what to do about that. We'll cover several case studies to help support any assistance you might have with a client looking to help you calculate the maximum contribution they can contribute to an HSA when they are getting ready to enroll in Medicare.

The most significant thing here is for folks who do elect to defer past age 65, how to apply those rules. Some confusion depends on a variety of mixed circumstances. Finally, we will review the Medicare enrollment and rules to start.

The Basics of Health Savings Accounts

HSAs are not necessarily a huge place to get revenue from an investment fee perspective for advisors. But the asset growth in HSAs is growing exponentially, and every time I update this slide, the numbers get even more significant.



There was a 73% year-over-year increase in funds in HSAs in the past year. Of course, some of that is due to investment growth in these numbers as of June 30, 2021, so that might be a little lower due to market movements in invested funds. Many of these are employer-related contributions. This leads to an opportunity when folks leave their companies or even before they leave their companies because one of the things about health savings accounts that is different from 401(K)s is that they are fully portable at any time.

A plan participant can still be enrolled in an HSA eligible plan, contribute through their paycheck, and still move their HSA assets to an outside provider from the provider that their employer set up for them. This is something I was regularly engaged with when I was employed.

A Review of Medicare Enrollment Rules

We are going to review the Medicare enrollment rules as they apply to HSA eligibility and cover how to contribute to HSAs past the age of 65. I have several case studies that we'll cover later that are based on questions I have received. I published an article on this topic last summer, so people regularly find me on the internet and send me very personal questions.

You probably know that there is no cost when you enroll in Medicare Part A. Turning age 65, as long as you are eligible for Medicare according to the work rules, you can enroll in Part A. Many people do that to ensure that they do not have issues with late enrollment, even if they choose to work past 65.

Medicare Part B is the part where there is a premium involved. If you miss the window to enroll when you are eligible and enroll late, there are lifetime penalties for that late enrollment. Depending on when you figure out that you messed up, there could be a gap in coverage because there is an annual enrollment period. Messing up and missing the enrollment date does not qualify you to enroll immediately; you will have to wait. There is a risk of getting this wrong.

Many people are disappointed to learn who will want to continue contributing to an HSA past 65. If you are already collecting Social Security, you are automatically enrolled in Medicare at age 65 or later. For folks who are still working but have reached their full retirement age from a Social Security perspective and decide to start collecting that additional income, they must understand that they are automatically enrolled in Medicare. Therefore, you are no longer eligible to contribute to a health savings account. Some of the calculating contributions and eligible contributions to HSAs can get complicated or confusing, and frustrating.

To defer Medicare Part B, you must have other qualifying coverage in place. Qualifying coverage generally means an employer-based group health plan for an employer with 20+ employees. I had a question on that this week. This person owns the company but has less than 20 employees. What is the rule there? The rule is more about the plan itself. Most health insurance plans say that if there are less than 20 participants and any participants are eligible for Medicare, they need to use Medicare as their first coverage. I referred this question back to the health insurance plan since this was a growing company that anticipated having more than 20 people in the plan sooner than later.

Generally speaking, if you have health insurance through your job and work for a larger company, or your spouse does, and you are on that plan, you can defer Medicare Part B until you lose that coverage. One thing that comes into play that people are often taken by surprise about is the idea of creditable coverage, which refers to the prescription drug coverage under Part D. You must be enrolled in Part B to be eligible for Part D. You would enroll in Part D for prescriptions if you were not on a Medicare Advantage plan.

But if you are looking to defer coverage to contribute to an HSA, you need to check to make sure that the prescription drug coverage provided by your plan is like what a Part D would offer. That often can be the thing that disqualifies the ability to defer Medicare coverage. Many HAS-eligible plans do not have creditable coverage for drugs. To answer whether you have it, you need to call your plan, and they should know whether or not the drug coverage is considered "creditable." That is a technical term. If you have creditable coverage and you are in an employer-based health plan, you can defer Medicare Part B as long as you have that coverage.

One type of coverage that does not qualify is COBRA. Sometimes folks will retire and go onto CPBRA for a little while or even plug the gap between figuring out self-employed insurance as I did myself. However, COBRA coverage is not qualifying coverage in terms of deferring Medicare Part B without penalty. Most self-employed insurance does not qualify as qualifying coverage, nor does individual coverage through the Exchange. For folks who are self-proprietors and purchasing their health insurance through the marketplace, when they turn 65, they will need to enroll in Medicare or get a job with a larger company.

Can You Contribute to a Health Savings Account (HSA) Past Age 65?

Say you have a client who would like to continue contributing to your HSA past the age of 65 and has qualifying coverage in place. HSA rules say you cannot contribute any other funds to a health savings account if you have other coverage behind that qualifying "high deductible healthcare plan." If you are enrolled in an HSA-eligible plan, which is the only coverage you have, you can contribute to an HSA. But if you have any other coverage, you are not allowed to put additional funds into your HSA.

This includes Tricare. It includes non-limited purpose flexible spending accounts (FSA) and even if you have a spouse who elects coverage into an FSA. A non-limited purpose FSA is where you could use your flexible spending account funds for anything. However, a limited-purpose flexible spending account is a great pairing for an HSA, a flex spending account that you can defer tax-free income to pay dental and vision costs and get those tax-free outside of HSA coverage. If you have a limited purpose FSA and an HSA that you are contributing to and have hit your deductible on your health savings account, then you can use your FSA for medical expenses.

Generally speaking, if you have a limited-purpose flex spending account and an HSA, the best practice is to put the maximum account into the health savings account. Do not touch that money if you do not have to, and use the flex spending account for what you estimate in dental and vision costs. That would include contact lens solutions, glasses, regular dental care, dentures, and anything applicable to those two types of services. That would allow you to have even more tax-free income for your anticipated medical expenses.

Beyond that, of course, the other coverage that cannot be in place for you to not contribute to an HSA is Medicare. The rule of thumb that we have had in practice basically since the beginning of Medicare was to go ahead and sign up for Medicare Part A on your 65th birthday just because it is generally offered at no cost. However, this needs a caveat if you have an enrollee covered in an employer-based plan that is HSA-eligible, they want to continue funding their HSA, and they are already enrolled in Medicare.

For example, let's say someone is age 66. They enrolled in Medicare on their 65th birthday because that is what they heard you are supposed to do. Then their employer decides to offer an HSA-eligible plan for employee healthcare. That individual may choose to enroll in Part B, or they can continue that employer-based coverage. They just cannot fund their health savings account. It is not that you cannot have coverage under an HSA-eligible plan after you are enrolled in Medicare; you just cannot put another dollar into your HSA.

Clearing Up a Few Misconceptions

That is really what a lot of the misconceptions go into this. There are many nuances about remaining eligible to contribute to the HSA beyond age 65, and I want to clear up a few other things that are often misunderstood.

1. Enrolling in Medicare only disallows further contributions to your HSA. That does not mean you cannot have coverage; you can still use funds in your pre-existing HSA to cover your eligible medical expenses. A best practice for HSAs is to allow those funds to accumulate. Ideally, you would invest them for tax-free income and then use them to fund your retirement healthcare expenses.

2. One interesting thing that many people do not realize about HSAs is that you can use them to reimburse yourself for Medicare premiums. Once you are on Medicare, if you have funds in an HSA and then pay Part B and maybe Part D premiums, you can take money out of your HSA tax-free to reimburse yourself.

3. You can also use your HSA for most long-term care insurance premiums and long-term care costs. If you have an insurance plan that you are funding to cover eventual costs, most of those qualify for HSA eligible costs. Then, of course, any healthcare expenses that would include hearing aids, dental care, and many things that are not necessarily covered by Medicare or tend to be higher medical expenses for retired folks can be covered tax-free by your HSA.

4. If you have healthcare expenses, i.e., larger ones like adding ramps to your home or upgrading your shower with bars that can help the taxpayer qualify for the medical expense deduction, you do not get to double-dip if you pay for it with your HSA. Most people do not even qualify for the medical expense deduction anymore on their tax returns because they are not itemizing. This is another way to make those expenses tax-free.

5. Finally, many people do not realize that once you are 65, you can take money out of your HSA for any purpose and just pay taxes on it. If you take money out of your HSA before you are 65 for non-medical expenses, there is a 20 percent penalty. Once you are 65, if you have excess funds saved and you do not have any medical expenses to support withdrawals, and you need some money out of your HSA, it is more like a 401(K) or a traditional IRA where you can just take the funds out and pay taxes on them. I do not see that happening much because most people have earmarked their HSA for medical expenses, and you do not know until the very end whether you will need those for medical expenses.

As we get some of the folks who are early in their career and really maximizing the HSA opportunity and possibly amassing six figures or more in an HSA, we may see more of those distributions coming about in the future. Some people are concerned about socking money away into a health savings account specific to medical expenses. Hopefully, this alleviates some of that concern about access after age 65.

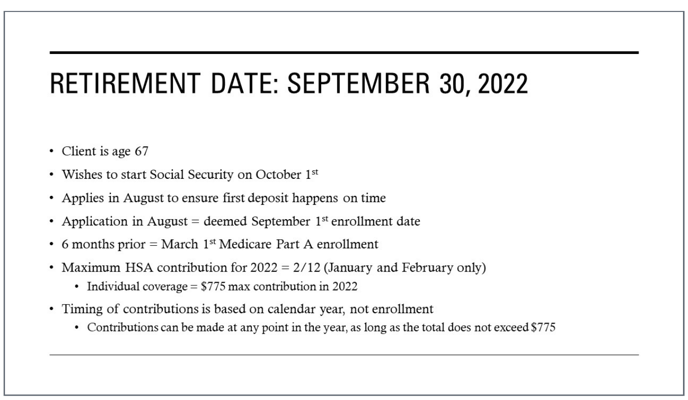
The Six-month Lookback Rule for Enrolling in Medicare

The big issue here is not just that enrolling in Medicare discontinues the ability to fund a health savings account. The big issue is a six-month lookback rule for folks who have deferred their Medicare enrollment. This is where I get a lot of panicked emails from consumers.

The six-month lookback rule says that you are deemed to be enrolled in Medicare Part A up to six months before the day you apply to enroll. If you enroll on your 65th birthday, it starts the first of your birthday month. If you apply after that, it starts the month after your 65th birthday. But the six-month lookback does not go before you turn age 65. If you are age 67 and you apply for Medicare because you are getting ready to retire, they deem you enrolled in Medicare Part B six months before the date of application.

Things can get sticky because that is when your eligibility for HSA contributions discontinues. Many people do not become aware of this rule until they enroll in Medicare. If you are applying for Medicare at age 65½ before, then you just need to stop HSA contributions on the first of the month of your 65th birthday. Still, after that, it is six months from the date of your *application*. This is a crucial thing to know about making sure you are not making ineligible contributions to an HSA, leading to penalties and unnecessary taxes.

Let's take a look at an example here. We have a person who has elected to retire on September 30, 2022.



Say someone is age 67 and wishes to start Social Security the day after they retire on October 1. Most people in a similar situation will apply in August to ensure that they are enrolled and that everything is set to go before they retire on September 30. Since that application date is in August, they are deemed enrolled in Medicare Part A on September 1, which means that there is the six-month lookback rule that deems them enrolled in Part B on March 1. The six-month lookback rule means you are enrolled in Medicare Part B six months before the application.

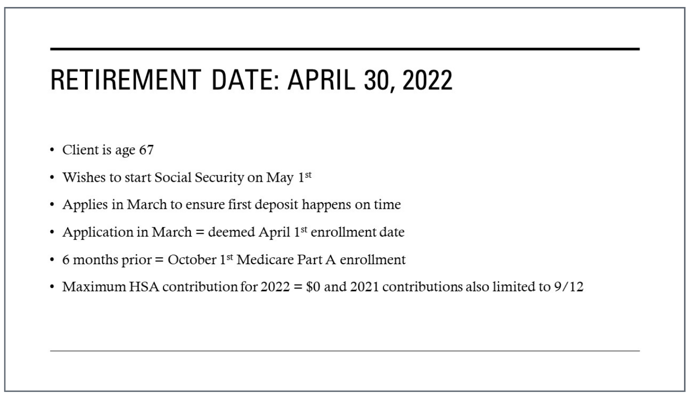
For 2022, that means you would only be able to contribute to your HSA for the months of January and February. This is based on the individual contribution, which would be a maximum of $4,650. Two-twelfths of that are $775. This person might not realize until maybe the following tax year when they file their taxes that they over-contributed, and they might instead stop their contributions on October 1.

They made six months of ineligible contributions that they might need to remove some funds. However, many people do not realize that the timing of their contributions is based on the calendar year. I had somebody doing $100 a month into their HSA, so they were not necessarily maxing out, but they had contributed or made payroll contributions beyond the six-month lookback. They were deemed enrolled in Medicare on April 1, and they had contributed in May. There was much panic about what do I do with this money?

But when we did the math, they were still within not making more than they were allowed to contribute for the year. If this person does not exceed the $775 total they can contribute for Tax Year 2022, it does not matter when that money goes in. One way to allow this client to make maximum contributions to their HSA while still having Medicare enrollment and coverage start as soon as they retire is to wait until September, allowing for one more month of HSA contributions.

If there is funding available, another option is to take advantage of the eight-month window to sign up after retirement. This special enrollment period for initial enrollment and deferred Medicare says that you have up to eight months after your employer coverage ends to apply without penalty. The six-month lookback period starts upon the date of application. If you apply six months after September 30, you will have your lookback to October 1, and then it will be all the same. That would require some funds on hand because you would not be starting Social Security until six months later. But there is a way to maximize the funds beyond just the typical rule of thumb and practice of getting all these applications ready to go before retirement.

Most folks prefer to have the application done and their coverage in place before leaving work. That makes perfect sense from a psychological perspective; most people are just going to not max out their HSA. But just a reminder that it can be delayed if maximum health savings account funding is a primary goal. But let us take a look at a more complicated scenario when a six-month lookback period takes us to the prior tax year. We have somebody who wants to retire at the end of April 2022. Same circumstances, age 67, wants to start Social Security the day after retirement..



They apply in March to make sure their first Social Security check is deposited on May 1. They are deemed enrolled in Medicare as of April 1, which is what the lookback takes them to October 1 for Medicare Part A, which is the prior tax year. The maximum contribution for 2022 to their health savings account is zero. They also have a limit on their 2022 contributions to the nine months out of the year that they were eligible since they are technically enrolled in Medicare Part A on October 1. What if they made a full 2021 contribution? There is a fix for that, as long as it is taken care of in a timely manner.

Using the previous example, let us say your client did contribute the full $4,600 that a 2021 individual aged 55 or older could contribute. Applying for Social Security in March of 2022 would make their Medicare Part A enrollment day October 1, 2021. This means they were only eligible for HSA contributions for nine of the 12 months, so they had three months of ineligible contributions made. Just a reminder also that the six-month lookback is only for clients over 65.

Since this person is 67, the six-month lookback period takes them back to October 1. The maximum that they could have contributed in 2021 turns out to be only $3,450. To avoid a penalty that could last the lifetime of the HSA, the client just needs to request a withdrawal of the $1,150 excess contributions by the April tax filing date. If you make a corrective request, you do not have to pay a penalty for those excess funds. This is typically a form that most HSA providers have on their websites. I accidentally made overcontributions to an HSA, and it was straightforward to pull it back.

If this client had put their $4,600 all in through a payroll deduction, then pulled that $1,150 out, they would have $1,150 in additional taxable income for 2021. They would get a 1099-SA from their provider to tell them what to include on their tax return. But suppose they are more like me, where maybe your HSA is outside of your employer, or you are making manual contributions where you, as the HSA account holder, log in and make a direct deposit. In that case, the deduction from your taxes does not even happen until you file your tax return. In this case, there would be no tax consequences to withdrawing those excess contributions.

Another case study is for a couple where a spouse is retiring and enrolling in Medicare. In this case, the working spouse is the younger spouse, age 63.

When the retired spouse turns age 65 and enrolls in Medicare, they are still on the working spouse's workplace plan as a backup to their Medicare. How much can the couple put into their HSA? The working spouse can do up to the maximum individual contribution for 2022. But because the retired spouse has other coverage, you cannot make a contribution based on their coverage.

Assume that the retired spouse enrolling in Medicare would then drop off the working spouse's plan and reduce the premium if that is a concern since most don't need double coverage. But there is a case where you might want to keep the spouse in Medicare on the healthcare plan, which would allow the working spouse to contribute up to the family maximum. The amount you can put in your HSA is based on your coverage amount and not necessarily on the other members of your family's eligibility to contribute, which is an interesting fact. Let us look at that in a different way that helps better explain what I am saying.

What happens when the facts are flipped, and the covered spouse enrolls in Medicare? Let us say the working spouse is 65, and they have a younger spouse who is 63, who is also on the plan. The working spouse wants to enroll in Medicare. But they maintain their workplace coverage for the non-working spouse to continue to have health insurance until they are 65. This is common for folks married to a younger spouse who is not working and does not have coverage.

CASE STUDY: MARRIED WITH ONE RETIRED

FACTS:

- Working spouse age 63
- Retired spouse age 65
- Retired spouse enrolls in Medicare

WHAT YOU NEED TO KNOW:

- Working spouse can contribute up to $4,650, maximum for individual in 2022

Assume that the retired spouse enrolling in Medicare would then drop off the working spouse's plan and reduce the premium if that is a concern since most don't need double coverage. But there is a case where you might want to keep the spouse in Medicare on the healthcare plan, which would allow the working spouse to contribute up to the family maximum. The amount you can put in your HSA is based on your coverage amount and not necessarily on the other members of your family's eligibility to contribute, which is an interesting fact. Let us look at that in a different way that helps better explain what I am saying.

What happens when the facts are flipped, and the covered spouse enrolls in Medicare? Let us say the working spouse is 65, and they have a younger spouse who is 63, who is also on the plan. The working spouse wants to enroll in Medicare. But they maintain their workplace coverage for the non-working spouse to continue to have health insurance until they are 65. This is common for folks married to a younger spouse who is not working and does not have coverage.

CASE STUDY: COVERED SPOUSE ENROLLS IN MEDICARE

FACTS:

- Working spouse age 65
- Covered spouse age 63
- Working spouse enrolls in Medicare
- Maintains workplace coverage for non-working spouse

WHAT YOU NEED TO KNOW:

- Working spouse cannot contribute to HSA nor can receive employer contributions
- Covered (non-working) spouse can open own HSA and fund up to $8,300 in 2022
- Why? Contribution limit determined by coverage type and covered by family
- Note that $1,000 catch-up requires separate HSA for non-covered spouse anyway

You might have somebody work a couple of years beyond age 65 so that their spouse can have coverage. In this case, the working spouse cannot contribute to the HSA, and they are also not allowed to receive any employer contributions. Employers will often make contributions to their participants' plans to encourage enrollment in this type of plan or provide additional compensation in a tax-favored way. But when you enroll each year in an HSA-eligible plan, the employer will ask if you have other coverage, including Medicare. So, it is a box you will probably have to uncheck or note so that the employer does not make contributions for the working spouse.

This is an area where, if it happens, maybe the spouse just does not check the correct box on their enrollment and then gets employer-based contributions. Then you would have just to make that ineligible contribution withdrawal and have it included in taxable income. It is not a super-emergency situation but knowing that they cannot get further employer contributions or contribute to their own HSA.

But the non-working spouse can. How much could they put in? The working spouse would put the family amount into their own HSA, and the covered spouse could do another $1,000, but they would have to contribute it into an HSA outside of work. While the working spouse is no longer eligible to contribute to their own HSA, we would assume that the covered, non-working spouse would already have an HSA in their name established that they would have been using to put their $ 1,000 catch-up contributions. They would just shift into contributing $8,300 for the family contribution and their own catch-up for 2022 into their own account.

Key Takeaways

1. Deferring Medicare enrollment past age 65 does make sense when you want to continue funding your HSA through an eligible employer-provided plan.
2. The six-month lookback for Part A Medicare enrollment must be considered in the year of retirement or enrollment in Medicare, especially for folks who are retiring in the first half of the calendar year because that often drifts back into the prior tax year.
3. Any ineligible contributions must be addressed before the April tax filing date.
4. A spouse who enrolls in Medicare on an HSA-eligible plan may affect contribution amounts. It depends on who is covered and what level of coverage is elected. If it is just two spouses and the non-working spouse is just dropping off of the plan to enroll in Medicare, it becomes individual coverage. Beyond that, it is generally still family contribution amounts, and just the Medicare-enrolled spouse cannot make the catch-up contributions as well.

Advance Planning for Clients with Health Savings Accounts (HSAs) and Medicare – Kelley Long

About Kelley Long, CPA/PFS, CFP®

Kelley Long is a personal finance expert and financial wellness coach who is on a personal mission to empower all people to feel and be great with money. She is a CERTIFIED FINANCIAL PLANNER® professional as well as a Certified Public Accountant, and is frequently cited in the media, including the NY Times, Wall Street Journal, Washington Post and Reuters.

She lives by her personal definition of financial security, which is using money to get to a place where you are able to make decisions in your life for every reason except money. She overcame her own poor money habits that lead to climbing out of 5-figure debt not once, but twice, as an example of how and why addressing the psychological aspects of money is as important, if not more so, than providing just financial education and planning.

With over 20 years of various roles in the financial services industry, Kelley left her most recent full-time position as a Senior Financial Planner and Personal Financial Coach with Financial Finesse after five years of changing the financial lives of employees throughout the US. Financial Finesse is often credited with starting the financial wellness industry in 1999 and is still the leading provider of unbiased workplace financial wellness programs – her experience there informs her consulting and speaking work today.

Kelley is a noted expert on Health Savings Accounts and their related financial planning strategies, having served over three years as a founding member of PSCA (Plan Sponsor Council of America), HSA Committee, an American Retirement Association affiliated organization, committed to advocating for the enhancement and adoption of HSA-friendly education and legislation.

After coaching over 2,500 individuals on their money and presenting to employees at several different Fortune 100 companies, Kelley has a deep understanding of how the concepts of behavioral finance can be applied to change behavior. She's a sought-after content creator, specializing in written pieces that support financial decision-making without getting bogged down in the jargon that so often intimidates and confuses readers.

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