Managing Social Security Benefits

Six areas to consider when trying to decide when to take Social Security benefits.

With national unemployment surpassing 10% officially (unofficially estimated at 15-17%), more and more clients in their sixties are addressing Social Security issues sooner than they expected.

While there are many variables to consider, following are six key focus areas that we discuss with our clients to help them better manage their benefits:

1. Early Retirement Benefits: When should I begin taking my benefits?
2. Taxation of Benefits: How can I minimize the tax on my benefits?
3. Delayed Retirement Credits: Does it make sense to postpone my benefits?
4. Spousal Benefits: When should my spouse take benefits?
5. Benefit Contingency Plans: How can I replace some/all of my benefits if Social Security changes?
6. Strategies to Consider: What tactics might enhance my lifetime benefits?

Early Retirement Benefits: Eligible recipients can begin receiving their benefits four to five years before their full retirement age (65-67 depending on year of birth). The major disadvantage is that benefits are reduced by 20-30% for the recipient's lifetime; spousal benefits can also be limited depending on circumstances.

Despite these drawbacks, about 73% of eligible Americans elect to receive early benefits (*SSA Annual Statistical Supplement*, April '08). Early benefits have appeal to those who are not working, need cash flow, and/or are concerned that Social Security's days may be numbered ("take the money and run" philosophy).

Helping clients calculate their "breakeven age" will help them decide when to start taking benefits. As an example, if you are currently 62 and your full retirement age is 66, your monthly benefit of $1,600 would be reduced to $1,200 (i.e. by 25%) if you started today. By about age 77, you could reach the breakeven point (i.e. total early benefits would equal those received at full retirement) at $230,400. The breakeven age increases to age 82 if we assume the early benefits were invested at 6% annually. So in this simplified example, if the client has a high probably of living past 77 (or 82, depending on your assumptions), he/she would be better off waiting until full retirement. The Social Security Administration's online calculator is a great resource to help with these calculations.

For those who take early benefits and are employed with compensation over the "earnings limit" ($14,160 for 2009), Social Security will take back $1 of benefit for every $2 earned over the limit. This continues until the year in which full retirement age is reached. During the year the person reaches full retirement age, the new earnings limit ($37,680 for 2009) applies only for the period before the month before he or she reaches full retirement age. If earnings exceed the limit in this period, benefits are reduced $1 for every $3 earned over the annual earnings limit.

The amount that is withheld, however, may not be lost. That is because the Social Security Administration (SSA) will, after full retirement age, recalculate the benefit amount and give credit for any months when benefits were reduced because of earnings.

Taxation Of Benefits: Benefits can be taxed as ordinary income, depending on the recipient's preliminary adjusted gross income (P-AGI). P-AGI includes earnings, pensions, interest, dividends, municipal bond interest and 50% of Social Security benefits. For P-AGI over $25,000 ($35,000 for married) 50% of benefits become taxable, and for P-AGI over $34,000 ($44,000 for married) 85% becomes taxable. This applies to all Social Security recipients. There is no age forgiveness. So, for clients whose income may be near these thresholds, it is important to coordinate discretionary income such as IRA withdrawals. We might also consider "bunching" income and deductions in alternate years.

Delayed Retirement Credits: For those who postpone benefits and continue working past full retirement age, their lifetime benefit can increase up to 8% for each additional year worked through age 69. The precise formula is based on birth year. So for a client who is 66 this year and entitled to $1,600 a month of full retirement benefit today, working an additional two years could increase their monthly benefit to $1,856. Thus, for clients who are active, in good health and have family history of longevity, there may be a benefit to continue working. (See this handbook from SSA.)

Spousal Benefits: For those age 62 and over whose spouses are alive and receiving benefits, they may be eligible for spousal benefits even if they do not have enough of their own work credits or have never worked at all. The maximum is 50% of the spouse's benefit and may be reduced depending on how many months prior to full retirement age that payments begin. Upon application, SSA will automatically pick the greater of the spousal benefit or actual benefit based on own work credits.

The wife's benefit may be optimized if she claims her benefit at age 62. (See a study by Steven A. Sass, Wei Sun Center for Retirement Research at Boston College). Because most husbands have higher lifetime earnings and shorter life spans, the women often receive the majority of spousal and survivor benefits. When a spouse dies, the survivor can claim the greater of their own earned benefit or their spouse's earned benefit. This may be reduced if claimed prior to full retirement age.

Benefit Contingency Plans: We prepare clients for a number of possible changes as the Social Security system works to remain viable. Proposals that may be considered include raising the ceiling on the maximum wage base from current levels ($106,800 in 2009) to $250,000; accelerating by five years the gradual increase in full retirement age to 67; modifying the benefit calculation to reduce benefit growth; and introducing "means testing" that could increase taxation and/or reduce benefits for recipients with household income over specified thresholds.

Whatever the outcome, it is critical that we offer clients "contingency plans" capable of replacing benefits that could be lost as a result. Here are some strategies we consider.

1. Taking Early Benefits And Investing The Cash: Consider the above example wherein a client begins his $1,200 early benefit at age 62 and invests it at 6% annually. After five years he would have about $57,811 accumulated, which could potentially generate the $400 per month difference (between full and early retirement benefit) for about 22 years. But if the money earns 3%, that benefit is only generated for about 13 years. Obviously much here depends on actual investment returns and longevity.

2. Make Up For Low Earnings Years: In general, for those born after 1928, benefits are calculated by averaging the 35 highest years of indexed earnings. For those who made little or nothing in one or more of those 35 years (often those who took off to raise family), waiting to retire until normal retirement age might increase benefits because each year they wait to retire gives a chance to earn enough to replace a lower year of earnings in the calculation.

3. Claim And Suspend: For couples with one wage earner who has reached Full Retirement, often the husband, he may allow his wife to receive spousal benefit now based on his earnings record by claiming then immediately suspending his benefit. This strategy would allow him to continue accruing delayed retirement credit, which would increase both his eventual monthly benefit plus the survivor benefit of his wife. The end result could enhance the couple's overall lifetime benefits.

4. Social Security Buy Back: Undoing a decision to receive early retirement benefits could be advantageous under certain circumstances. Say a couple, both now 70, took early benefits at 62 and now receive $11,556 annually. Had they waited until 70, they would be receiving $20,000 annually instead, despite their not having worked since age 62. If they each pay back $79,305 in benefit and reapply, they effectively purchased an additional $8,444 of annual inflation adjusted annuity benefits. A comparable commercial annuity, according to Economics Professor Laurence J. Kotlikoff of Boston University, might have cost them 40% more.

The downside is that up to 85% of the benefit could be taxable, whereas the commercial annuity would include return of principal and therefore be less taxed.

The bottom line is, there are no hard and fast rules: Each client situation needs to be evaluated based on their individual circumstances. Also, while we can educate, there is no substitute for the client having a face-to-face meeting with a Social Security Administration representative and consulting their tax advisor. As advisors we can add tremendous value by making clients aware of the various issues and guiding them through their decision making process.

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