RETIREMENT

What Everyone Should Know Before Claiming Social Security Benefits

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> 10 important points in deciding whether or not to begin claiming Social Security

Because nearly two-thirds of retirees receive more than half of their income from Social Security, there can be no doubt that the choice of when to claim benefits is one of the most important financial planning decisions a client can make. Yet there is clearly a disconnect between what clients are doing and what clients should be doing. Much of the recent research in this area has focused on one of three reasons why deferring benefits may be beneficial: 1) a cost efficient-way to generate more guaranteed income; 2) a way to address the risks of inflation and longevity; and 3) a strategy for leaving potential widow(er)s in better financial shape. Unfortunately, according to Henry J. Aaron and Jean Marie Callan of the Center for Retirement Research at Boston College, in their research report working paper "Who Retires Early," beneficiary claiming behavior doesn't seem to have caught up with the research, as a vast majority of beneficiaries claim Social Security benefits prior to full retirement age (more than half claim at age 62), and only 1.5 percent wait until age 70 to begin benefits. One probable reason for this is a lack of understanding by clients of their benefit options and the implications of their claiming decisions. To help retirees make better decisions, here are 10 key points that everyone should know.

In retirement, everyone will have to plan to meet basic expenses for an entire lifetime, and these expenses will increase with inflation.

1. REPLACE PRE-RETIREMENT INCOME

With most Americans struggling to afford retirement, deferring Social Security benefits can be the simplest and most effective way to improve retirement security. A retirement income plan revolves around replacing lost earnings, and the longer Social Security benefits are deferred (at least up to age 70), the higher the percentage of pre-retirement earnings replaced by Social Security benefits. Take, for example, a married couple. Both are currently age 61 and each earns $60,000 a year. Using Social Security's Quick Calculator (ssa.gov/oact/quickcalc), if they both begin worker's benefits at age 62, Social Security replaces 23 percent of the couple's $120,000 income, 32 percent at 66 and 45 percent at age 70, assuming that they continue to work until benefits begin. (Note that if the individual stopped working earlier, for example age 62, and defers benefits until later, the replacement rate at 66 and 70 will generally be somewhat smaller, because average earnings are likely to be lower.) The same result would occur with a single person earning $60,000. The replacement rates (at all claiming ages) are higher for married couples with a single wage earner because of the additional spousal benefit paid on the same earnings. At the very least, before making a claiming decision, be sure to convert estimated monthly benefit amounts at different claiming ages into replacement rates. When estimating benefits, it is important to consider accurate assumptions about whether one plans to stop working prior to receiving benefits or will continue to work until benefits begin, and the IRS has several online calculators for estimating benefits. Even better, make a comprehensive retirement income plan first, and then make the claiming decision in the context of that comprehensive plan.

For those worried about making ends meet in retirement, a better way to frame the question is: "What is the least expensive way to increase guaranteed lifetime income?"

2. LOCK IN A WAY TO PAY FOR BASIC EXPENSES

In retirement, everyone (regardless of income) will have to plan to meet basic expenses for an entire lifetime, and these expenses will increase with inflation. Social Security provides an inflation-adjusted annuity guaranteed by the government, and payable for life. Cost-of-living adjustments (COLAs) are applied to an individual's monthly benefit. COLAs are tied to the consumer price index for urban wage earners and clerical workers (CPI-W). COLAs are effective with monthly benefits for December, which are normally paid in January.

With fewer retirees eligible for guaranteed income from company pensions today, Social Security is often the only available source of guaranteed lifetime income. Deferring Social Security means a higher guaranteed benefit and a higher proportion of retirement income receiving cost-of-living increases. Additional annuity income can be purchased, but commercial annuities will either provide no inflation protection or limited protection for a significant additional price. Note that commercial annuities with inflation protection tied to CPI increases will generally cap annual inflation increases to limit the risk to the insurance company. Other products offer a stated increase (such as 3 percent) each year and are not tied to the CPI. Also note that research has shown retirees with greater amounts of guaranteed income show more satisfaction, worry less and show fewer signs of depression, according to W. Canstantijn and A. Panis in their "Pension Research Council Working Paper (2003-19)." Increasing guaranteed income through deferring Social Security may be good for your health!

3. GET THE MOST FROM THE SYSTEM

Everyone wants to get the most bang for their buck from Social Security. Some believe that the best bet is to take early because they won't get their money's worth unless they live a long life. Essentially, this is betting on dying young—a bad gamble—as losing means living a long life with too little income. For those who are worried about making ends meet in retirement, a better way to frame the question is: "What is the least expensive way to increase guaranteed lifetime income?" Given the high cost of a commercial annuity that offers inflation and survivor protection, deferring Social Security may very well be the lowest-cost way to accomplish this goal. There will be some wealthier individuals well funded for retirement who will focus more on the expected present value of lifetime benefits assuming different benefit start dates. Even though the Social Security system is designed so that individuals will receive approximately the same expected present value for retirement between ages 62 and 70, there is a major exception to this rule. Because of the widow(er) benefit, married men living the average life expectancy who retire and begin benefits early will receive a smaller present value than if they defer, according to "When Should Married Men Claim Social Security Benefits?" by Sass, Sun and Webb of the Center for Retirement Research at Boston College (Issue Brief #8-4, March 2008). A break-even analysis does underscore an important point: A person in bad health at retirement with a short life expectancy should probably claim early. However, caution is advised because a married person taking early may leave the widow(er) with a permanently reduced benefit. Break-even analysis also would suggest that a longer-than-average life expectancy weighs in favor of deferring, and those with more education and income have longer life expectancies than average, according to the Congressional Budget Office in "Growing Disparities in Life Expectancies," (Economic and Budget Issue Brief, April 17, 2008).

4. CONSIDER FUTURE CHANGES IN SOCIAL SECURITY

Future changes in Social Security are appropriate to consider in a claiming decision, but don't think that because Social Security anticipates future financing problems that claiming early is always the best choice. There will be changes, but benefits are not likely to be modified for current retirees and those close to retirement. Social Security is just too important to the retirement security of seniors, and its financial problems are solvable with reasonable modifications to the program.

5. UNDERSTAND BENEFITS

It's important to understand the impact of claiming benefits at different retirement ages for both the worker's and spousal benefit.

- **Worker's benefit:** Workers who claim benefits at full retirement age (which is currently age 66 and rises gradually to age 67 for those born after 1959) receive a benefit that is 100 percent of what is called the primary insurance amount (PIA). Benefits can begin as early as age 62, but beginning before full retirement means a permanent reduction based on the number of months that benefits begin prior to full retirement age. (Note: The early retirement reduction is 5/9 of one percent for each month up to 36 months and 5/12 of one percent for each additional month that benefits begin prior to full retirement age.) At 62, for example, a person with a full retirement age of 66 receives a benefit of 75 percent of PIA. On the other hand, claiming after full retirement age results in an 8 percent increase for each full year retirement is delayed, up to age 70. With a full retirement age of 66, an individual waiting until age 70 to claim earns 132 percent of the PIA. Because the delayed-retirement increase stops at age 70, there is no advantage to further delaying benefits beyond age 70.
- **Spouse's benefit:** Once a worker has claimed benefits, a lower-earning spouse is entitled to a spousal retirement benefit at full retirement age of 50 percent of the worker's PIA. The spousal benefit is also available as early as age 62, but again will be subject to an early-retirement reduction. The reduction is tied to the spouse's (and not the worker's) age when benefits begin. Spousal benefits cannot begin until the worker has claimed benefits, but workers are allowed to claim and then suspend once they have attained full retirement age (without receiving any benefits) to trigger eligibility for spousal benefits. It's also important to know that spousal benefits are not eligible for a delayed-retirement increase if benefits begin after full retirement age, meaning that there is no reason to defer spousal benefits beyond full retirement age (currently, age 66).

8. BE AWARE OF DIVORCED SPOUSE'S BENEFITS

Divorced spouses whose marriages lasted for at least 10 years may be eligible for both spousal retirement benefits and widow(er) benefits based on the former marriage. Divorced spousal retirement benefits can begin as early as age 62, even if the former spouse has not claimed benefits (something a current spouse cannot do), as long as the worker is eligible for retirement benefits and the couple has been divorced for at least 2 years. Similarly, divorced spouses age 60 or older (or age 50 if disabled) are eligible for widow(er) benefits. The divorced spousal benefits do not count against other benefits paid to the worker and current family. Spousal retirement benefits for divorced spouses are paid to unmarried individuals only, so an individual remarried at the time benefits are payable will be disqualified. The widow(er)'s benefit is a bit different as remarriage after age 60 does not disqualify the former spouse from eligibility for the widow(er) benefit from the former spouse.

9. TAKE ADVANTAGE OF ELIGIBILITY FOR MULTIPLE BENEFITS

Beneficiaries eligible to receive more than one benefit may, in some cases, be able to benefit from deferring the more valuable benefit, but still taking a different benefit at a younger age. Here are several examples:

- Spousal benefits taken first. At or after full retirement age, a married (or divorced) spouse may have the option to claim the spousal benefit and claim the worker's benefit later—at age 70—to maximize the worker's benefit. (Remember: A currently married spouse can begin a spousal benefit only if the worker has claimed benefits. However, the worker can claim and suspend to trigger eligibility for the spouse.) An eligible divorced spouse can take advantage of the same rule. This option is not available if benefits are claimed before full retirement age, because under the deemed-filing rule an individual filing before full retirement age is treated as claiming both benefits, if eligible.
- Worker's benefits taken first. The spouse with a small worker's benefit may consider claiming benefits from his or her own earnings history at 62, and once the higher-earning spouse retires, receive the higher spouse's benefit. The deemed-filing rule is not an impediment here since the spouse is not entitled to the spousal benefit until the worker claims retirement benefits.
- Widow(er)s benefit options. A widow eligible for both widow's benefits and worker's benefits can choose one benefit and later choose the other. For example, a widow could take a reduced widow's benefit at age 60 or 62 and then switch to her maximum retirement benefit when she reaches age 70.

10. UNDERSTAND THE EARNINGS TEST AND VOLUNTARY BENEFIT SUSPENSIONS

An individual who has claimed early and is under age 70 may still have an opportunity to suspend benefits to maximize future benefits. There is mandatory suspension under the earnings test prior to full retirement age and voluntary suspension after. If an individual begins to receive benefits prior to full retirement age and earns more than the current threshold (generally $14,160), benefits are reduced under the earnings test. Most see this as a complete loss of benefits, but it's actually a forced suspension. At full retirement age, benefits are automatically recalculated, assuming a later retirement age based on the number of months that benefits were suspended. For example, if under the earnings test an individual loses six months of payments, at full retirement age benefits are recalculated based on a retirement age that is six months later than under the initial calculation. After full retirement age, an individual can elect to voluntarily suspend, which again allows a future increase in benefits. These rules have the most significance for those that are involuntarily terminated and need to begin benefits early. If they are lucky enough to get another job, they can suspend benefits, hopefully to age 70.

CONCLUSIONS

Choosing when to claim Social Security benefits is a decision that can affect long-term financial security. Deferring benefits can improve the financial situation for many, and is an excellent way to finance basic retirement expenses for everyone—as Social Security is an inflation-adjusted annuity payable for life. Married men, in particular, should consider deferring to improve their wives' financial situation after they die. Unfortunately, many people are making decisions without all the information. With a better understanding of the rules and the financial impact of the claiming decision, retirees can better protect themselves and their retirement security.