Understanding Ins and Outs of Social Security Benefits is Vital for Retirement Planning

By Scott Whyte, AAMS®

Social Security is an important part of any retirement planning discussion. Understanding the ins and outs of Social Security Benefits and how they work in conjunction with your investment portfolio, pension and other sources of retirement income can be confusing. Once you understand what benefits you and your spouse may qualify for, deciding when to start the benefits, and how those benefits will impact other areas of your retirement plan such as pension payments or withdrawals from your portfolio, takes serious planning and consideration.

The most important factors to consider with regard to Social Security Benefits can be summarized by the following:

• Your individual benefit amount and whether it makes sense to apply based upon your earnings or your spouse's earnings.

• Age at which you are eligible for and/or should begin taking benefits.

• Maximum benefit you qualify for and the impact of taking benefits before or after your Full Retirement Age (FRA).

• Tax implications of drawing benefits prior to FRA.

• Whether you should delay drawing Social Security Benefits and draw from your portfolio instead in order to maximize your Social Security Benefits.

Understanding your Benefit Amount

In looking at Social Security, the first thing you need to understand is how your benefits are calculated. The Social Security Administration, prior to 2011, would send a Social Security Benefit statement annually which gave a breakdown of your potential benefits. They discontinued that service in April 2011 which was estimated to cost approximately $70 million annually to print and mail. Now, you need to go to their website at www.ssa.gov and access that information online or talk with your nearest Social Security office. With the widespread availability of the internet to citizens in the US, especially when you take into account free availability at most public libraries, I am glad the government cut their expenses in this one area by eliminating paper statements.

When starting to review your Social Security Benefits, this statement is a great place to start. In addition, the Social Security website provides you with a variety of resources to determine benefits you may be eligible for and includes online tools and calculators to help you estimate your potential benefits.

Also, keep in mind, that for a spouse who earned significantly less than their higher-earning spouse, it may also make sense to apply for benefits based upon their spouse's earnings rather than their own earnings. Generally, the benefit will amount to 50% of the higher-earning spouses benefit if you take benefits at your Full Retirement Age. If you start drawing at age 62, you could receive as little as 32.5% of the higher-earning spouse's benefit amount. This calculation will not show up on your personal benefit statement, but should always be considered in any planning scenario. The Social Security Administration can provide this information if they are contacted via phone toll-free at 1-800-772-1213 or at your nearest Social Security office.

Benefit Amount Changes Based on When You Take Benefits

For most people, as long as you have worked for 10 years, you become eligible for Social Security Benefits as early as age 62. However, by taking benefits at age 62, you will receive a permanently reduced benefit. Therefore, many people wait until their Full Retirement Age (FRA) is reached to take benefits. If you can wait beyond your FRA to take benefits (up to age 70) you will receive an even higher monthly benefit amount than if you started drawing benefits at FRA. For anyone born in 1943 or later, you increase your benefit amount by 8% for each year you delay past your FRA.

Your Full Retirement Age (FRA) is based on the year you were born. Persons born between 1943 and 1954 reach FRA at age 66. If you were born after 1954 and up to 1960, your FRA increases by two months each year. If you are born after 1960, then 67 is your FRA.

For example, if you were born in 1965, then your FRA would be age 67. Then, if you took your Social Security Benefits at age 62, the amount you would receive would be reduced by 30 percent, and the reduction rate would diminish each year by approximately 5% to 6% until age 67 when you would have no reduction in benefits. However, if you delayed past age 67, you would increase your benefit by 8% each year up to age 70 for a maximum benefit equal to 124% of the amount you would've received had you drawn at age 67.

From an actuarial point of view, drawing at age 62 or FRA are considered equivalent if you live until age 82. However, due to COLAs (Cost of Living Adjustments), the break even age is actually about 76. Thus, every year that a person who draws at 62 lives past age 76 they are then falling behind on the amount they could have received had they waited until their FRA to start collecting.

Determining When to Take Your Benefits

Deciding when you, and your spouse, should take your Social Security Benefits is a very personal and irrevocable decision. First, many people are working well into their 60s and may not need the money at age 62 or even at their Full Retirement Age. However, some people have health conditions that preclude them from working and Social Security Benefits become a much more vital part of their retirement income earlier than most other individuals. It is also important to factor into your Social Security Benefit decision any other sources of income you may be receiving such as a pension and/or withdrawals from a retirement portfolio. For example, if you are comfortable living off of your company pension and do not need additional income to supplement your living expenses, you may wish to delay Social Security Benefits rather than taken them early which, ultimately, increases the monthly amount that you receive for the rest of your life. Also, if you receive a pension, but your spouse does not, it may be necessary for one or both of you to take Social Security Benefits early in order to supplement the pension amounts.

You Could Lose Benefits by Taking Them Too Early

If you continue working and decide to draw benefits prior to your Full Retirement Age (FRA) you may lose some of your monthly benefit. For instance, if you are still working at age 62 and start drawing benefits, you will lose $1 in benefits for every $2 of earned income over $15,480 (amount is adjusted annually for inflation). However, if you are not working, but your spouse is working, you will not lose benefits. This particular aspect of Social Security is tied to your individual earnings rather than joint earnings. In most situations, it does not make sense to draw Social Security Benefits prior to FRA while you are working and earning more than $15,480.

Some advisors suggest that you draw benefits immediately upon reaching age 62, even if you don't need the income, and invest the monies every month, but generally, I do not approve of that strategy. In most situations, it makes sense to defer benefits, which allows you to receive a larger monthly benefit for the rest of your life once you do start drawing (and needing) benefits.

You May Pay Taxes on Your Benefits

You may pay taxes on Social Security depending on a variety of factors. No one will pay taxes on more than 85 percent of their Social Security Benefits. For joint filers, you will generally start paying taxes on a portion of your Social Security Benefits if your "Provisional Income" is above $32,000. Provisional Income is calculated as follows:

Your adjusted gross income

+ Nontaxable interest

+ ½ of your Social Security benefits

= Your "Provisional Income"

Thus, by owning municipal bonds or bond funds you will not necessarily avoid paying taxes on your Social Security benefits as the interest on those investments is added back into the equation. However, deferring income by avoiding or reducing withdrawals from IRAs or deferring income by investing in an annuity can help you to avoid paying tax on your Social Security Benefits. Remember though, that avoiding taxes on your benefits may be insignificant when compared to the high price of a variable annuity or other tax-deferral strategy if you do not carefully consider all costs and fees associated with those programs.

Delaying Benefits by Drawing from Your Portfolio

Generally speaking, the best way to maximize your Social Security Benefits is by delaying, up until age 70, to receive benefits. As mentioned earlier, your benefit increases 8% each year you delay past your Full Retirement Age (FRA). There is also a strategy known as “file and suspend”, which can be used to maximize benefits where the lower earning spouse would draw a spousal benefit only once both husband and wife reach age 66, and the higher earning spouse, or both, would delay receiving a full benefit based on their own earnings until age 70.

If you retire before age 70 and want to maximize your Social Security benefits by delaying receipt until age 70, generally, you are looking at withdrawing from your investment portfolio to cover your income gap assuming that there is one.

The problem with this strategy is that an investment portfolio tends to be more volatile and fluctuates more so than the steady and reliable fixed income you would receive when taking Social Security Benefits. Further, the erosion of your investment principal in the early years of retirement if the market performs negatively while you are drawing from it could make it difficult to recover from. However, when you take into account that your Social Security Benefit increases by 8% each year you delay, this can be a strong motivator and is very powerful when you consider the higher amount will continue to be paid for the rest of your life (and/or your spouse’s life).

What you are banking on is that you live long enough to recoup the amount you didn’t receive by waiting to draw benefits and that the reduction in your portfolio from withdrawals doesn’t otherwise impede your ability to attain your long-term goals. Because of COLAs (Cost of Living Adjustments), the breakeven age for those who delay until age 70 to draw benefits is approximately age 78.

In summary, there are a variety of important factors to consider when making decisions about your Social Security benefits. Some issues such as divorced spouse benefits, widow benefits and a more thorough discussion of file and suspend strategies were not included in this article in order to keep it a reasonable length, but you may need to consider those or other issues as well. Furthermore, the long-term viability of the Social Security program has been called into question for a variety of reasons, but most planners including ourselves consider that the program will continue to pay for the foreseeable future. While these decisions can be easy for many of us, not all situations are easy to wade through. As always, if we can be assistance in helping you with your Social Security planning or retirement planning in general, please do not hesitate to contact us at 248-932-5200.

Scott Whyte is a financial advisor with Bloom Asset Management and has been successfully serving client's investment needs since 1988. Scott joined Bloom Asset Management in 2000 and provides Investment Management services to individual, small business and high net-worth clients. Prior to joining Bloom Asset Management, Scott was Vice President and Branch Manager at Charles Schwab's Southfield, office where he was responsible for $1.5 billion in client assets.

Scott has received his designation as an Accredited Asset Management Specialist (AAMS) through the College for Financial Planning in Denver, Colorado. In the past, he held various licenses through FINRA while working on the broker-dealer side of the industry including Series 7, 8 & 63. Currently, he holds a Series 65 (Investment Advisor) license.

Scott lives in Troy, Michigan with his wife and three children, including one set of twins.