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FEATURE ARTICLE

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Social Security Benefits

Overview: For many individuals, Social Security represents a significant portion of their income in retirement. The following discusses Social Security basics and items to consider regarding when benefits should start.

The Basics

According to the Social Security Administration, Social Security benefits represent about 40 percent of the income for the elderly. Social Security benefits are essentially guaranteed income that:

- Is adjusted for inflation
- Is free of investment risk
- Is protected against longevity risk
- Comes with a death benefit for married individuals

These benefits often are a significant source of retirement income and unlike any other income or investment vehicle. Thus, it is important to know how to optimize lifetime benefits.

Benefits are determined by birth year, retirement age and lifetime earnings. Once workers reach full retirement age (FRA), they are eligible for full retired worker benefits, also known as the primary insurance amount. Currently, the FRA is from age 65 to age 67 depending on year of birth.

Workers who claim benefits prior to reaching FRA will receive a reduced benefit of up to 25 percent of the primary insurance amount. Delaying a claim until age 70 results in a larger benefit of up to 32 percent more than the primary insurance amount due to cost-of-living adjustments and delayed retirement credits.

Most retirees take benefits as soon as possible. In fact, 71 percent of male retirees and 76 percent of female retirees claim Social Security benefits early. Yet the longer claiming is delayed, the greater the benefits. There are several factors to consider before taking Social Security benefits, including current health, life expectancy, employment status, other income sources and taxes.

Taking Benefits Early

Those in early retirement with no other significant income sources may have to take benefits early as their only option. Those taking early retirement due to health problems should consider applying for Social Security disability benefits as well. Qualifying retirees could receive a benefit equal to the primary insurance amount through a combination of early Social Security benefits and disability benefits and would be converted to full retirement age benefits once they reach FRA.

Individuals who believe they have a below average life expectancy should also consider taking benefits as soon as possible. In addition, some married women can optimize household benefits by claiming early and collecting a higher spousal and survivor benefit later.

Those taking benefits early to supplement earnings income should keep in mind that $1 of benefits will be deducted for every $2 earned above the annual limit, which is $14,160 for 2009. In the year individuals reach their FRA, $1 of every $3 earned above $37,680 (annual limit for 2009) will be deducted from their benefits for the earnings received before the month they reach FRA.

This only includes the earnings in the months prior to reaching FRA. Essentially, this creates a temporary 50 percent tax on any earnings above the annual limit until reaching FRA, but a permanent reduction in Social Security benefit of up to 25 percent. Once a person reaches FRA, their benefits have no limit on earnings.

However, this shouldn't discourage anyone from working while receiving Social Security benefits. The Social Security Administration automatically reviews earnings records and replaces the lowest earnings in individuals' work records with their latest year of earnings if it is higher. Higher earnings could result in a higher benefit for those who have not yet hit the maximum Social Security benefit.

Delaying Benefits

On the other hand, delaying Social Security generally optimizes lifetime benefits. This is especially true for married couples due to additional benefits such as spousal and survivor benefits. For those who have the financial flexibility to delay until FRA or beyond, retirees will receive either the primary insurance amount or up to 32 percent over the primary insurance amount at age 70. Delaying can potentially offer the following benefits:

- ▲ A higher guaranteed-annuity-like benefit with cost-of-living adjustments
- ▲ A higher benefit for spouses who elect for spousal benefits
- ▲ A higher benefit paid to the surviving spouse
- ▲ A higher benefit that will act as longevity insurance (protection against outliving assets)
- ▲ An elimination of reduction of benefits if collecting Social Security and still earning income
- ▲ The option to withdraw from retirement accounts to reduce future required minimum distributions, which begin at age 70 1/2
- ▲ The ability to draw higher Social Security income (tax-advantaged) instead of higher retirement account income (taxable)

Summary

The decision of when to take Social Security benefits depends on the individual and his or her circumstances. Deferring benefits allows for higher annual payments and other potential benefits such as higher spousal and survivor payments. Also, the higher benefits received from delaying can act as longevity insurance. A good way to determine the best strategy is to work with an advisor and contact the Social Security Administration to find out what estimated benefits will be at age 62, 66 (or FRA) and 70.

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APPENDIX:
Taxation of Social Security Benefits

Up to 85 percent of Social Security benefits can be taxed as ordinary income if total income exceeds a certain level. About one-third of those receiving Social Security payments owe income taxes on their benefits. Social Security income is not taxed the same as IRA income, so investors can reduce their taxes by choosing higher Social Security income and lower IRA income when developing their strategy for taking retirement income.

Taxes on Social Security benefits depend on investors' income relative to tax thresholds:

Social Security Benefit Tax Thresholds		
	Individual	**Married**
No tax	Less than $25,000	Less than $32,000
First tax threshold	$25,000–$34,000	$32,000–$44,000
Second tax threshold	$34,001+	$44,001+

However, taxation is not calculated based directly on income, but rather on combined income. The formula for calculating combined income is:

Combined Income = Adjusted Gross Income (AGI) + Nontaxable Interest + ½ of Social Security Benefits

Once the combined income is determined, the figure is compared to the table above. The combined income formula calculates the tax on the smallest of:

- 50 percent of the excess over the first threshold, plus 35 percent of the excess over the second threshold
- 85 percent of the benefits
- 50 percent of the benefits, plus 85 percent of any excess over the second threshold

Here's an example of a married couple filing jointly:

- AGI $50,000
- Tax-free bond interest $2,000
- ½ of $20,000 in Social Security benefits $10,000
- Combined income $62,000

When compared to the table above, this couple has an income of $30,000 above the first threshold and $18,000 above the second. Those numbers are plugged into the three options for calculating Social Security taxes, and the smallest result is chosen:

50% of excess over first level + 35% of excess over second level	(0.5 * $30,000) + (0.35 * $18,000)	$21,300
85% of total benefits	(0.85 * $20,000)	$17,000
50% of total benefits + 85% of excess over second level	(0.5 * $20,000) + (0.85 * $18,000)	$25,300

Source: 2009 Mercer Guide to Social Security

In this example, the second option is the smallest amount. Therefore, income taxes will be calculated based on a new AGI of $67,000 ($50,000 + $17,000). In other words, $17,000 (85 percent) of Social Security benefits will be taxed.