Tax Action Memo®

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Deciding When to Start Receiving Social Security Benefits

Type of Clients: Individuals. **Situation:** The client is approaching age 62 and needs to decide when to start taking social security retirement benefits. **Deadline:** N/A.	**Tax Action Required:** Read this release so that you're ready to help clients decide when to start receiving social security retirement benefits.

Background

Workers are generally entitled to begin taking monthly social security retirement benefits once they reach age 62. However, the full benefit will be permanently reduced for each month the benefits are received before the individual reaches the full retirement age. On the other hand, benefits increase if the individual delays receiving benefits until after reaching the full benefit retirement age. Thus, a client approaching age 62 will need to decide whether to begin taking reduced social security benefits early or wait until full benefit retirement age (or later).

Note: A worker's full retirement age varies depending on the worker's birth date. The full retirement age is 66 for workers born after 1942 and before 1955, it's age 67 for those born after 1959, and it's somewhere between age 66 and age 67 for those born after 1954 and before 1960.

Practice Tip: Social security benefits are calculated by reference to the primary insurance amount (PIA), whether the worker is fully insured, and a number of other factors. Since the calculation is complicated and many of the factors change each year, the most practical way to estimate the PIA may be to have it done by the SSA. An estimate of benefits can be obtained from a local social security office or by submitting Form SSA-7004-SM (Request for Social Security Statement).

For many clients, the present value of the social security retirement benefits they would receive is similar regardless of when benefits begin, depending on their life expectancy and tax bracket. Therefore, in many cases, this decision will depend on factors other than trying to receive the greatest lifetime benefit from social security.

Practice Tip: The Social Security Administration provides a break-even age calculator at **www.ssa.gov**. This tool helps clients find the age at which total benefits received is equal at different starting dates.

Some clients will delay retirement and continue to work because of personal preference. Yet others will want to retire early and will need to start receiving benefits as soon as possible. Some clients choose to take early social security benefits out of necessity—they are unemployed or underemployed, or they have an immediate financial need. Those in a better financial situation often have the luxury to wait and allow their benefits to increase, thus ensuring a more comfortable retirement. These are the clients who can best benefit from your help.

Note: While clients may have the option of retiring early and beginning to receive social security benefits immediately, the eligibility age for Medicare remains at 65. So, although they may be able to replace a sufficient amount of their earned income with social security benefits at age 62, they may not be able to adequately replace their employer-provided health insurance. While recently enacted health care legislation should help this situation, it's too early to tell exactly how much.

Factors to Consider in Taking Reduced Benefits at Age 62

Even if the retiree has sufficient funds to live on without considering social security, some practitioners advise clients to begin receiving benefits as soon as possible. For 2010, the benefits at age 62 are reduced by 25% of what they would be at age 66 (i.e., the full benefit retirement age), but the client will receive more social security checks if benefits are drawn early. In addition, drawing early social security benefits may allow the client to leave tax-deferred retirement accounts untouched and growing for longer periods.

Example: Beginning social security benefits at 62 versus the full benefit retirement age.

Curt, who was born in 1948, plans to retire on his 62nd birthday in 2010 when his PIA is $1,000. If he begins drawing benefits at age 62, he will receive monthly social security retirement benefits of 75% of his PIA, or $750. Thus, he will have received 48 benefit checks of $750 each, a total of $36,000, when he reaches age 66 (his full benefit retirement age). His benefit would be $1,000 if he waited until age 66 to begin receiving benefits, so it would take more than 11 years before the increased $250 per month ($1,000 − $750) equaled the $36,000 he would have received between ages 62 and 66. Therefore, Curt would receive 15 years of benefits beginning at age 62 before he would receive the same amount of total benefits if payments had started at age 66, as shown as follows:

Benefits beginning at age 62 for 15 years ($750 × 180 months)	$135,000
Benefits beginning at age 66 for 11 years, 3 months ($1,000 × 135 months)	$135,000

Bottom Line: If the client waits until the full benefit retirement age to draw benefits (and the PIA remains the same), it will take around 11 years to reach the break-even point to make up for the years of payments that were not received. Therefore, if the client does not expect to live until age 77, more benefits will be received by taking the reduced monthly payment.

If the present value of future social security benefits is considered, it would normally be more favorable to start the benefits as soon as possible. However, if the client is using early social security benefits to replace a similar amount of earned income, the short-term position will not be improved and the long-term outlook will suffer.

Factors to Consider in Waiting until Full Benefit Retirement Age

Those who reach age 62 and desperately need retirement income may not have the option of waiting until their full benefit retirement age before they begin receiving benefits. And those with a shorter life expectancy might be wise to start receiving benefits as soon as they can because they may not receive them for very long. However, other retirees should carefully consider the long-lasting advantages of waiting until their full benefit retirement age. Factors to consider include:

- *Life Expectancy.* The client's life expectancy may be the biggest factor in deciding whether to receive social security benefits early. While tables and averages are available, a 62-year-old client should have a good handle on his or her own life expectancy. Current health and the longevity of parents should be clearly established by that age. In general, 80 years might be a good cutoff point. If the client reasonably expects to reach that age, waiting until the full benefit retirement age may be a wise choice.

- *Shortening the Retirement Period.* A significant factor in retirement planning projections is the length of the retirement period. This is determined by subtracting the age at retirement from the life expectancy. For example, if a client wants to retire at age 62 and has a life expectancy of 85, there is a 23-year retirement period to fund. By working past age 62, the client is shortening the retirement period and decreasing the resources needed to fund the retirement regardless of longevity.

- *Replacing Lower-wage Years.* As stated earlier, an individual's social security benefits are based on his or her PIA. The PIA is calculated from the individual's highest earnings during a 35-year calculation period. If a client can replace lower-wage years early in his or her career with higher-wage years after age 62, the PIA can be increased. This can lead to a dramatically higher retirement benefit when the individual retires.

- *Inflation Adjustments.* Social security benefits receive an annual inflation adjustment. By taking early benefits, the individual will be receiving a smaller annual dollar increase and will miss out on the compounding effect of that increase. For example, if an individual's PIA was $1,000, but he or she retired early and received only $750, each year he or she would miss out on the compounded inflation adjustment of that $250 in lost benefits. In other words, the gap between the early retirement benefit and the amount he or she would have received by waiting will get bigger and bigger.

- *The Effect on the Spouse.* The individual's decision to start receiving social security benefits before reaching the full benefit retirement age may also affect a spouse's benefits. Unless the spouse has personal earnings record and is fully insured, he or she will be dependent on the working spouse's PIA for retirement benefits. A spouse who waits until full benefit retirement age is eligible to receive 50% of the working spouse's retirement benefit. However, a worker who retires early may have a lower PIA than by waiting until the full benefit retirement age. Therefore, the spouse's benefit would be based on that lower PIA.

- *The Earnings Test.* Clients who are considering receiving social security retirement benefits before their full benefit retirement age but who also intend to keep working need to consider the impact of the earnings test. Under this test, social security benefits are reduced $1 for every $2 in earnings above an exempt amount of earnings ($14,160 for 2010) if the client has not yet reached full retirement age. Thus, clients already facing a reduced benefit amount because of their early retirement would have their benefits reduced even further by failing the earned income test.

Example 2: Effect of taxes and social security benefits reduction on excess earnings.

Charlie retired in 2009 at age 63. In 2010, he decides to work part-time and earns wages of $15,160, $1000 over the exempt amount. Charlie has investment income and is in the 25% marginal tax bracket. His social security benefits are subject to tax and 85% of the benefits are included in his gross income. Since Charlie is under the full benefit retirement age, his benefits are reduced $1 for each $2 he earns over the exempt amount. Charlie's additional spendable portion of the additional $1,000 in income after considering taxes and the loss of social security benefits is only $280, shown as follows:

Earnings over the exempt amount	$ 1,000
Social security tax on $1,000 (7.65%)	(76)
Income tax on $1,000 (25% marginal tax bracket)	(250)
Loss of social security benefits ($1,000 ÷ 2)	(500)
Tax savings from $500 reduction in benefits ($500 × 85% × 25%)	$ 106
Additional spendable amount	$ 280

Factors to Consider in Beginning Benefits after Reaching the Full Benefit Retirement Age

An individual who works past the full benefit retirement age receives larger benefits because of the delayed retirement credit. A worker born in 1943 or later receives a credit of 8% per year for each year the worker delays receiving benefits after reaching the full retirement benefit age until age 70.

Special Strategies for Increasing Retirement Benefits

Switching from One Type of Benefit to Another. A married taxpayer who has reached full benefit retirement age and wants to earn delayed retirement credits (and thus receive a larger retirement benefit) may, in the meantime, claim a spousal benefit while continuing to work. Then, when the taxpayer has earned additional delayed retirement credits, he or she can switch from spousal benefits to benefits based on his or her own (now higher) PIA. To implement this strategy, the taxpayer's spouse must already be receiving retirement benefits, for only then may spousal benefits be claimed.

Example 3: Switching from a spousal benefit after earning delayed retirement credits.

Bo and Jo have both reached full benefit retirement age. Bo wants to retire and start receiving his benefit of $1,800 per month. Jo's benefit (based on her earnings record) is only $800 per month. So instead, Jo receives the higher spousal benefit of half of Bo's benefit ($900). However, if Jo chooses to continue working while receiving her spousal benefit, she will continue to earn delayed retirement credits until age 70. At that point, she would be eligible for a larger retirement benefit of at least $1,056 based on her own earnings record (8% delayed retirement credit × 4 years × $800).

Claiming Then Suspending Benefits. Occasionally, a worker may wish to delay benefits to take advantage of the delayed retirement credit, but the spouse may wish to receive his or her spousal benefit immediately. Since the spouse may only receive spousal benefits when the worker has begun drawing benefits, this creates a problem. However, a potential solution exists. The worker may file for benefits at full benefit retirement age, thus allowing the spouse to file for spousal benefits. The worker can then immediately suspend benefits to earn the delayed retirement credit, while the spouse continues to receive spousal benefit. (This strategy is allowed under the Senior Citizens' Freedom to Work Act of 2000.)

Example 4: Receiving spousal benefits while the worker earns delayed retirement credits.

Al and his wife Jo had both reached their full benefit retirement age. Al's PIA was $2,000, but he intended to keep working and earn delayed retirement credits until age 70. Jo wanted to retire, but her PIA was only $500. Since Al was not going to retire and receive benefits, Jo was not eligible for her $1,000 ($2,000 × 50%) spousal benefit based on Al's earnings. However, their planner advised Al to file for benefits so Jo could claim her higher ($1,000 rather than $500) spousal benefit. Then, Al immediately suspended his benefit claim and continued working. Jo was permitted to continue receiving her $1,000 spousal benefit and Al could continue to accrue delayed retirement credits.

Variation: Assume that Jo wants to retire at age 62 instead of her full benefit retirement age (66). She files for a reduced benefit of $375. When Al reaches his full benefit retirement age, he files for a spousal benefit of $250 (50% × $500), but continues to work and earn delayed retirement credits. At age 70, he retires and files for benefits based on his earnings history. He stops receiving his spousal benefit of $250, but he now receives his own retirement benefit. The delayed retirement credits he earned have increased his benefit by 32% ($2,640 instead of $2,000).

The increase in benefits caused by the delayed retirement credit does not increase the PIA and does not affect benefits paid to family members other than the worker and, eventually, the surviving spouse. In addition, even after beginning to receive social security retirement benefits, a worker can earn a delayed retirement credit for any month that suspension of benefits is requested. This option only applies to the period beginning with the month in which the worker reaches the full benefit retirement age and ending with the month prior to reaching age 70.

Reimbursing SSA for Early Benefits. Some clients may want to consider applying for social security benefits before the full benefit retirement age with the intention of repaying the amount in full later. This strategy is best suited for clients who do not need the social security benefits to live on but can invest the full amount, or can avoid taxation of their social security benefits so as not to reduce the investable amount.

This strategy allows the client to invest the reduced early retirement social security benefits for up to four years, repay SSA the total amount of the received benefits (without penalty or interest) at full retirement age, retire at that point and receive the full (unreduced) benefit, and keep any earnings received on the investment. Form SSA-521, (Request for Withdrawal of Application), is used to implement this strategy.

One risk of this strategy is that the client may die shortly after filing Form SSA-521 and never receive much of the higher full retirement age benefit after repaying SSA thousands of dollars. However, this risk may be somewhat mitigated by the advantage of the surviving spouse receiving a higher spousal benefit. Another risk is that the client may die before filing Form SSA-521, leaving the spouse with permanently reduced benefits. This risk can be mitigated by purchasing a life insurance policy that expires at age 70.

Conclusion

Clients approaching age 62 will need to decide when to start receiving social security benefits. As described in this release, many factors will need to be considered. As their trusted advisor, you'll likely be the one they will call for help.

Subscriber Note: This *Tax Action Memo* is based on material from *PPC's Guide to Retirement Planning*. For information on this guide, visit **ppc.thomsonreuters.com** or call (800) 431-9025.