KANAWHA
CAPITAL MANAGEMENT
Fourth Quarter 2015

This Quarter's Highlights

- "File and Suspend" and "Restricted Application" Strategies for Couples Coming to an End
- Impact of the New Rules on Divorcee and Survivor Benefits
- Social Security Planning Is Still Important
- Factor the Survivor Benefit into Breakeven Analysis for Couples
- Social Security "Hold Harmless" Provision

KANAWHA CURRENTS

Changes to Social Security Planning for Couples

Recently approved legislation in the Bipartisan Budget Act of 2015 has removed two popular Social Security retirement planning strategies. Couples who are already taking advantage of the so-called *File and Suspend* and/or *Restricted Application* techniques are grandfathered under the old rules. Those nearing Social Security retirement age may still be able to use one or both strategies depending on their age and when they apply. Otherwise, these two loopholes will be closing as a result of the new legislation.

"File and Suspend" Before the New Rules

Before the recent change, a married individual eligible for Social Security benefits could choose to file and suspend (delay) their benefit in order to unlock a spousal benefit. Therefore, their spouse could choose to begin taking a spousal benefit up to 50% of the worker's Primary Insurance Amount (PIA) if he or she was at Full Retirement Age (FRA). At the same time, the individual who filed and suspended would be earning Delayed Retirement Credits (DRCs) on his or her individual benefits. These credits would increase the worker's future benefit by 8% per year, or up to 32% by age 70. The advantage to this strategy was that a couple could begin receiving a spousal benefit even while the primary earner was deferring his or her individual benefit.

File and Suspend example:

John Doe is eligible for a $2,000 monthly Social Security retirement benefit on his 66th birthday. He decides to file and suspend his individual benefit so that his wife, Jane, also age 66, could begin receiving her spousal benefit. While she receives $1,000 a month, John's future benefits will be increasing by 8% per year until he reaches age 70. In fact, for every month that John defers beyond his Full Retirement Age of 66, he permanently increases his future benefit by a small percentage amount (2/3 of 1% per month). Not only will John increase his future benefit, but Jane's potential survivor benefit will increase by the same amount, assuming she outlives him.

"File and Suspend" After the New Rules

As a result of the new legislation, File and Suspend is effectively coming to an end. If an individual files and then suspends his benefit, he will also be suspending privileges for a spousal benefit to be received based on his earnings record. In other words, a couple will not be able to receive a spousal benefit while the eligible earner defers. If they want to generate a spousal benefit, the eligible individual must file and *begin* receiving benefits.

The effective date for the new rules is April 30, 2016, or 180 days after the legislation was signed into law on November 2, 2015. This means that eligible individuals who reach Full Retirement Age (FRA) of 66 before April 30 of 2016 will be grandfathered under the old rules as long as they file and suspend on or before April 29, 2016. Those who do not reach the age of 66 by this date *and* do not file and suspend by this date will no longer be able to take advantage of *file and suspend.*

"Restricted Application" Before the New Rules

While the file and suspend strategy involved a primary worker trying to get his or her spouse a spousal benefit while earning delayed credits, filing a *restricted application* was designed for someone to get his or her *own* spousal benefit while delaying his or her own individual benefit. Unlike file and suspend, which could work for married couples with only one Social Security eligible earner, the restricted application strategy required two eligible earners. Under this approach, one spouse applied for benefits and the other spouse filed a restricted application. The spouse filing the restricted application received spousal benefits while deferring his or her individual benefit and earning delayed retirement credits.

Restricted Application example:

John Doe, age 66, has an eligible benefit of $2,000 while his wife, Jane, also age 66, has her own benefit of $1,500. Jane decides to file for her benefit, while John decides to delay his benefit in order to earn a higher benefit at a 70. In the meantime, John files a restricted application so that he can receive a spousal benefit from Jane. Not only will John get a higher amount at age 70, but he will also receive a spousal benefit while he waits.

Married couples with two Social Security eligible individuals could pair the restricted application strategy with the file and suspend approach if they both wanted to defer their individual benefits while also getting paid to wait. Typically, the primary earner would file and suspend, allowing the spouse to file a restricted application for a spousal benefit. In this case, they both would be earning delayed credits on their individual benefits, potentially receiving up to 32% more by age 70, while still receiving a spousal benefit during the deferral period.

File and Suspend & Restricted Application example:

From the previous example, John files and suspends, while Jane files a restricted application to receive her spousal benefit. Under this scenario, they both defer their individual benefits to age 70, growing John's monthly benefit to $2,640 ($2,000 + 32%) and Jane's to $1,980 ($1,500 + 32%). During the four-year wait, Jane receives her spousal benefit of $1,000 per month.

"Restricted Application" After the New Rules

As a result of the new rules contained in the Bipartisan Budget Act, the restricted application approach is coming to an end. Going forward, an individual who files for benefits is deemed to be filing for both their individual and spousal benefits. Social Security will automatically pay them the higher of the two benefits. Therefore, one will not be able to file for only their spousal benefit, which was the intent of the restricted application.

Importantly, the date for when the new rules go into effect is more lenient than for file and suspend. Those individuals who turn 62 by the end of 2015 will be grandfathered under the old rules. This means that someone who is 62 today can choose to file a restricted application when they reach their full retirement age of 66 in 2019. So, while file and suspend will effectively come to end on April 30, 2016, filing a restricted application will be in play for a few more years for those who are age 62 and older by the end of 2015. Of course, this means those who are already using the restricted application strategy will be grandfathered under the current rules.

Impact of the New Rules on Divorcee and Survivor Benefits

Individuals who are divorced or widowed also need to be aware of how the new rules might affect them. Divorced spouses are still eligible for benefits if they were married for at least 10 years, are currently unmarried, age 62 or older, and their ex-spouse is eligible to receive benefits. These rules have not changed with the new legislation. What has changed is the ability for a qualified ex-spouse to file a restricted application at his or her full retirement age and collect a spousal benefit while deferring their individual benefit to a later date. Under the new rules, only those divorced spouses who reach age 62 by December 31, 2015, will be eligible to file a restricted application for spousal benefits on their ex-spouse's earnings record. All other divorced spouses who are under the age of 62 at the end of 2015 will no longer be able to file a restricted application.

Surviving spouses will not be impacted by the new legislation. Surviving spouses who are age 60 and older are still eligible for survivor benefits up to the full amount of the deceased spouse's benefit. Survivor benefits are not available for surviving spouses who remarry before age 60. Remarrying after age 60, however, will not preclude one from getting survivor benefits based on a former spouse's record. Surviving ex-spouses may also be eligible for survivor benefits if they meet certain conditions.

Social Security Planning Is Still Important

While some of the Social Security planning opportunities for couples have been removed, individuals and couples preparing for retirement still need to make important decisions regarding the timing of benefits. The new rules have not changed the basic trade-off of foregoing benefits today in exchange for receiving higher benefits in the future. Eligible individuals can still choose to begin benefits as early as age 62 (generally age 60 for survivor benefits), but payments will be permanently reduced if taken before one's full retirement age. Conversely, one can still choose to defer benefits beyond FRA and permanently increase benefits all the way to age 70. Note that spousal benefits can also begin at age 62 (if the earner spouse has applied for benefits) at reduced amounts, but spousal benefits do not continue to increase if deferred beyond FRA (unlike the individual benefit).

We can analyze the tradeoff of deferring smaller payments today in exchange for larger payments tomorrow by using a simple *breakeven analysis*. A breakeven approach is used to determine how long it will take for higher future benefits to make up for deferred early payments. If we are deciding between taking at age 66 and delaying until age 70, we can add up the payments we would receive from ages 66 to 69 and then divide this by the incremental monthly benefit accrued from waiting. If one expects to live beyond the age at which the breakeven period falls, they may choose to delay benefits to age 70.

It should be noted that this simple approach ignores inflation, the time value of money, *and* the opportunity cost of growth on early benefits. Under a more realistic scenario, the higher the assumed growth rate, the longer the breakeven period will be. For example, let's say John Doe is choosing between taking Social Security at age 66 and deferring to age 70. If he chooses to take at 66, he will avoid the need to withdraw $2,000 per month, or $24,000 per year, from other assets. Any growth he could get on these monies would be added to the cumulative early payments of $96,000 in our equation above, which would increase the breakeven period. The higher the rate of return he can earn on these monies, the longer it would take for larger future payments to play catch-up, and the more beneficial taking early would be.

Factor the Survivor Benefit into Breakeven Analysis for Couples

For married couples, Social Security planning should incorporate how survivor benefits are calculated. The new legislation has not changed this premise. Since

Figure 1: Simple Breakeven Analysis

Monthly Payment at Age 66 = $2,000
Total Early Payments from Age 66 to 69 = $96,000 ($2,000 x 48 months)
Increase in Monthly Payment If Delay to Age 70 = $640 ($2,640 - $2,000)
Simple *Breakeven Period* = $96,000/$640 = 150 months or 12½ years

survivor payments are based on the deceased spouse's benefit, it may be prudent for couples to consider earning delayed credits for the primary earner's benefit. This is because the decision to defer can potentially add value until the last to die for a married couple. This should be factored into the breakeven analysis discussed earlier. The odds of at least one of the two spouses living beyond the breakeven period will likely be higher than basing the odds on only one life. Considering the life expectancy of both spouses rather than just the primary earner's longevity is an important aspect of Social Security planning for couples.

Conclusion

Once the new rules prohibiting *file and suspend* and *restricted application* go into effect, married couples will no longer have the opportunity to "get paid" to wait for their individual Social Security retirement benefits. Earners will still be able to defer and earn delayed retirement credits on their own benefits, but they will not be allowed to turn on a spousal benefit while deferring their individual benefits. This was the basic premise behind the file and suspend and restricted application strategies. Married couples had the ability to claim some (spousal) benefits today, and then claim higher benefits in the future. Going forward, they can still choose to defer and earn higher benefits in the future, but they cannot receive spousal benefits in the meantime. For some, this may make the decision to defer benefits beyond full retirement age more difficult. For others, it may still be prudent to delay for as long as possible in exchange for larger future benefits.

The optimal strategy depends on one's specific circumstances. As with many financial decisions, what may be a good decision for one individual or couple may not be a sound decision for another family. While certain factors such as health may be out of our control, it makes sense to educate oneself on the different options available and then formulate a strategy that offers the best combination of maximum lifetime benefits and longevity protection. Understandably, some individuals may adhere to *the bird-in-the-hand* theory: Take the benefits as soon as they are eligible. Others may feel their good health and family history justify an approach of delaying benefits to reap the highest future payments.

Social Security "Hold Harmless" Provision

Social Security has a "hold harmless" provision, which protects most recipients from experiencing declines in their net benefits due to Medicare Part B premiums increasing by more than the annual Social Security cost-of-living adjustment. The rule applies only to those individuals who are enrolled in Medicare Part B and who are receiving Social Security benefits. It does not apply to those who have enrolled in Part B but have deferred their Social Security. It also doesn't apply to higher-income earners who are subject to the Medicare Part B "surcharge." Lastly, it doesn't apply to new Part B enrollees who, if newly enrolled in 2016, will now pay $120 per month versus those who will pay $104.90 thanks to being protected under "hold harmless." Notably, the recently approved Bipartisan Budget Act prevents a more dramatic increase in Medicare Part B premiums for those not protected by the hold harmless rules. Without the new legislation, monthly premiums for those not covered under the hold harmless provision would have increased to about $159, significantly higher than the $120 put into effect under the new Act.

Source: http://docs.house.gov/meetings/RU/RU00/CPRT-114-RU00-D001.pdf