Kanawha Capital Management, LLC

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# Kanawha Currents

## This Quarter's Highlights



## Settle on a Strategy for Social Security

Social Security retirement benefits represent an important source of income for many retirees. Even for those families who don't rely heavily on Social Security to meet their income needs, it is prudent to reap the greatest economic benefit out of what you contributed into the system over your working years. We will identify the different factors that determine your potential benefit amount as well as discuss the basic rules of receiving benefits. We will also explore some of the various strategies that may allow individuals and couples to maximize their Social Security and minimize longevity risk.

### The Basics

Social Security benefits are calculated based on a worker's highest 35 years of earnings, up to the annual Social Security wage base. As long as an individual has at least 40 quarters of covered work, he or she will be entitled to his or her own *individual* benefit. These earnings are then used to calculate one's Primary Insurance Amount (PIA). The PIA represents the monthly retirement benefit an individual would receive at his or her Full Retirement Age (FRA). FRA is dependent on year of birth and is 66 for those born between 1943 and 1954, and increases to age 67 for people born in 1960 or later (Figure 1).

In addition to individual benefits, *spousal* and *survivor* benefits may also be available for spouses, divorcees, and widows. Whether a spouse is covered or not under their own work experience, he or she may also be eligible to receive a spousal benefit from a current or divorced spouse. Married individuals are eligible to receive spousal benefits of up to 50% of their spouse's PIA. Divorced spouses may also be eligible for benefits if they were married for at least 10 years, are currently unmarried, age 62 or older, and the ex-spouse is eligible to receive benefits. You must wait at least two years if your divorced spouse is eligible to receive benefits but has not yet applied for benefits.

A survivor benefit is generally available for widows and widowers who are age 60 or older. A surviving spouse is eligible to receive up to the full amount of the deceased spouse's benefit. Survivor benefits will not be available for surviving spouses who remarry prior to age 60. Remarrying after age 60, however, will not preclude you from getting survivor benefits based on your former spouse's record. Divorced spouses may also be eligible for survivor benefits if they meet certain conditions. Note that the FRA for a surviving spouse may be different than the normal FRA depending on the spouse's year of birth.

## Taxes

Depending on your *combined* income and filing status, you may be required to pay ordinary income taxes on up to 85% of your Social Security benefits.

*Combined Income* = Your Adjusted Gross Income + Nontaxable Interest + ½ Social Security Benefits

## The Earnings Test

Those individuals who are considering taking Social Security before their FRA *and* who are still working should be aware of the *earnings test*. Social Security will withhold 50 cents in benefits for every dollar of earnings above certain thresholds. The test is more forgiving for those who are still working during the actual year in which they reach their FRA. Even though this rule may encourage deferring benefits until one's FRA, workers who are subject to this withholding will receive a credit in the form of higher payments once they reach their FRA. In other words, withheld benefits are not lost forever.

## The Tradeoff: Take Early and Receive Less or Take Later and Receive More

Perhaps the most important rule to be aware of in Social Security planning is that retirement benefits as a percentage of PIA are permanently reduced if taken before FRA. Conversely, individual benefits are permanently increased if deferred until after FRA. Essentially, while benefits may begin as early as age 62 (generally age 60 for survivor benefits), one can increase future benefits for each month/year they choose to delay.

**Figure 1: Full Retirement Age and the Effect of Early or Delayed Retirement Benefits**

| Year of Birth | Full Retirement Age | Delayed Retirement Credit | Benefit, as a % of PIA, Beginning at Age: | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | | 62 | 63 | 64 | 65 | 66 | 67 | 70 |
| 1943 - 54 | 66 | 8%/Yr | 75 | 80 | 86 2/3 | 93 1/3 | 100 | 108 | 132 |
| 1955 | 66, 2 mo. | 8%/Yr | 74 1/6 | 79 1/6 | 85 5/9 | 92 2/9 | 98 8/9 | 106 2/3 | 130 2/3 |
| 1956 | 66, 4 mo. | 8%/Yr | 73 1/3 | 78 1/3 | 84 4/9 | 91 1/9 | 97 7/9 | 105 1/3 | 129 1/3 |
| 1957 | 66, 6 mo. | 8%/Yr | 72 1/2 | 77 1/2 | 83 1/3 | 90 | 96 2/3 | 104 | 128 |
| 1958 | 66, 8 mo. | 8%/Yr | 71 2/3 | 76 2/3 | 82 2/9 | 88 8/9 | 95 5/9 | 102 2/3 | 126 2/3 |
| 1959 | 66, 10 mo. | 8%/Yr | 70 5/6 | 75 5/6 | 81 1/9 | 87 7/9 | 94 4/9 | 101 1/3 | 125 1/3 |
| 1960 - later | 67 | 8%/Yr | 70 | 75 | 80 | 86 2/3 | 93 1/3 | 100 | 124 |

Source: Social Security Administration

Please note these figures are for individual benefits only. Spousal and survivor benefits have different schedules.

The incentive to delay the individual benefit is actually the greatest after one's FRA. Someone born in 1950 would permanently increase their future benefits by 8% per year for every year they defer in real dollar terms. These are referred to as delayed retirement credits. Not only will you receive a higher portion of your PIA, but you may also receive annual cost-of-living adjustments on these higher payments.

Similar to individual benefits, spousal and survivor benefits are reduced for every month they are taken before the spouse's FRA. Spousal benefits decline by about 30% if taken as early as age 62. Unlike individual benefits, which accrue delayed credits beyond FRA up to age 70, spousal and survival benefits do not. They stop increasing at one's FRA. Therefore, there is no advantage to waiting beyond their FRA for those who are eligible only for a spousal or survivor benefit. We will discuss more about couples planning for Social Security using spousal and survivor benefits later.

## Assessing the Tradeoff: Breakeven Analysis

We can analyze the tradeoff of foregoing smaller payments today in exchange for larger payments tomorrow by using a simple *breakeven* analysis or *present value* calculation. A breakeven approach can be 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.

**Figure 2: Simple Breakeven Analysis**

Monthly Payment at Age 66 = $1,500

Total Early Payments from Age 66 to 69
= $ 72,000 ($1,500 x 48 months)

Increase in Monthly Payment If Delay
to Age 70 = $480 ($1,980 - $1,500)

**Simple *Breakeven* Period**
= $72,000/$480 = 150 months or **12 ½ years**

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 takes at 66, his monthly benefits would be $1,500. If he chooses to delay, he will need to take $1,500 per month from his other investments to support his living expenses. So by taking early, he avoids the need to withdraw $1,500 per month, or $18,000 per year, from other assets. Any growth he could get on these monies would be added to the cumulative early payments of $72,000 in our equation above, which would increase the breakeven period. The higher the rate of return he can earn on these monies, the more beneficial taking early will be and the longer it would take for higher future payments to play catch-up.

## Assessing the Tradeoff: Present Value Calculation

Another approach to gauging the optimal time to start benefits is through a present value calculation. It should come as little surprise that the Social Security Administration has structured benefits to be actuarially fair. In other words, the present value of benefits will be approximately equal, whether one decides to take smaller payments earlier or larger payments later, assuming normal life expectancy. If, however, one expects to live beyond his or her life expectancy, then deferring to age 70 may maximize the present value of lifetime benefits. On the other hand, taking early would maximize benefits if one was unlikely to reach their normal life expectancy.

## What If I Outlive My Assets?

Many retirees choose to define *risk* as the possibility of outliving their assets. In other words, in the event they live well beyond their normal life expectancy, there is greater chance of them depleting their financial resources. Compounding this problem, many of today's employers are transferring post-retirement risk to employees as they shift from defined benefit plans to defined contribution plans. Generally, the best solution to mitigate this longevity risk with Social Security benefits is by deferring payments until delayed credits stop accruing at age 70. Deciding to use Social Security for longevity protection is not unlike other insurance decisions. Homeowners purchase property insurance to protect against certain risks to their homes. If nothing bad ever happens, they would have lost their premiums, but this

is a much better alternative than not paying for insurance and being responsible in the event their house was lost to a catastrophic fire. If one delays Social Security and then dies prematurely, they would have lost out on some benefits, but many retirees would prefer this scenario over the risk of taking benefits early and running out of resources due to increased longevity.

## Planning for Couples

Spousal and survivor benefits often create planning opportunities that are unique to married couples. As previously mentioned, spouses are eligible to receive benefits of up to 50% of their spouse's PIA, while surviving spouses can receive up to 100% of the deceased spouse's benefit.

### File a Restricted Application

In some cases, a spouse who is eligible to receive his or her own benefit at FRA may be able to receive spousal benefits while still earning delayed credits on the individual benefit. This can be done by filing a *restricted application*, which makes the spouse eligible for a spousal benefit without compromising his or her individual benefit. This is typically beneficial in cases where the spouse's individual benefit already exceeds or will ultimately exceed his or her spousal benefit after accruing delayed credits. Usually, the lower-earning spouse would be the one to file the restricted application. It should be noted that the other spouse must have applied for his or her benefits to make this option available.

### File and Suspend

Another popular strategy for couples is the so-called *file and suspend* approach. One spouse (normally the primary income earner) files for benefits at his or her FRA and then immediately suspends payments. This allows the other spouse to be able to collect a spousal benefit based on the primary earner's record, while still allowing the primary earner to accrue delayed credits. When appropriate, couples may pare this strategy with the restricted application strategy.

### Factor the Survivor Benefit into Breakeven Analysis

Couples' Social Security planning should also incorporate how survivor benefits are calculated. Since survivor payments are based on the deceased spouse's actual benefit (not their PIA), 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.

## Summary

In conclusion, planning for Social Security retirement benefits can be a complicated process. The optimal strategy depends on one's 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. No matter how dependent one will be on the benefits, retirees should approach Social Security as another important tool in their set of financial resources.