The Age You File Will Impact the Size of Your Checks

With Social Security, Time Really Is Money

by Alexandra Armstrong, CFP

In its 2012 annual report to Congress, the Social Security Board of Trustees announced that the projected point at which the combined trust funds will be exhausted comes in 2033, three years sooner than projected last year. But we think (hope) changes will be made so that the funds won't run out. There are various proposed solutions, such as increasing the Federal Insurance Contributions Act (FICA) taxes workers pay, increasing the amount of benefits subject to taxation, reducing cost-of-living increases or increasing the retirement age. Despite the gloomy forecast, we think Social Security will be around for a long time and that it'll continue to play a significant role in retirement planning.

One of our clients' most frequently asked questions is when to claim Social Security retirement benefits. After all, most people working today won't receive pension income, so Social Security may be their only source of retirement income outside of their investments. We wish we could tell you there's one ideal age at which to start receiving Social Security, but it really depends on your circumstances. We'll give some examples of how timing can make a big difference.

First, let's review how your age impacts your benefits. Your Full Retirement Age (FRA) is the age at which you can receive unreduced benefits. This used to be 65 for everyone, but now it can be as late as 67 depending on when you were born. Note that even if your FRA is later than 65, you're still eligible for Medicare benefits at age 65. Everyone still has the option of claiming retirement benefits as early as age 62, but the reduction can be as high as 30 percent (*see table, this page*).

For example, a person born in 1950 who's eligible to receive $1,000 per month at age 66 would receive only $750 per month if benefits begin at age 62. Effective March 29, 2011, the Social Security Administration no longer sends workers and former workers benefit statements. Those statements show your estimated benefits, FRA and annual earnings. Until the statements are available online, it's prudent to call the Social Security Administration at 800/772-1213 and request a statement at least every three years.

Review this statement to make sure the earnings shown are accurate so that you'll get everything due when you apply for benefits. If you're eligible for widow(er)'s benefits, or benefits based on a divorced spouse's record, they'll not be reflected on the statement. To determine your benefits in those cases, contact the Social Security Administration.

Benefits are designed to be actuarially equivalent to whether you take them at 62, full retirement or somewhere in between. Based on average life expectancies, a lower benefit paid for a longer time will add up to be the same as a higher amount paid over a shorter period. So why not take benefits as soon as possible?

Full Retirement and Age 62 Benefit by Year of Birth

Year of Birth	Full Retirement Age	Benefit Reduction by Year of Birth
1937 or earlier	65	20.00%
1938	65 + 2 mos.	20.83
1939	65 + 4 mos.	21.67
1940	65 + 6 mos.	22.50
1941	65 + 8 mos.	23.33
1942	65 + 10 mos.	24.17
1943-1954	66	25.00
1955	66 + 2 mos.	25.83
1956	66 + 4 mos.	26.67
1957	66 + 6 mos.	27.50
1958	66 + 8 mos.	28.33
1959	66 + 10 mos.	29.17
1960 and later	67	30.00

Source: Social Security Administration

What's Your Life Expectancy?

Most people don't die at the average life expectancy, so you have to take into consideration your expected longevity based on family history and your own health. According to the Social Security Administration, one out of every four 65-year-olds will live past age 90, and one out of 10 will live past age 95, so you or your survivor may end up receiving Social Security income for a lot longer than you might think. If you live longer than average, you're generally better off in the long run waiting to receive higher benefits.

Once you know the amount that would be paid at 62 and your FRA, you can compute the simple break-even point to determine how long you'd have to live in order for delaying benefits to make sense. This is the age at which the cumulative amount of delayed benefits equals the cumulative benefits if you started receiving them at 62.

For example, assume a retiree who is 62 years old can receive $1,500 per month now or $2,000 per month by waiting until age 66. If the retiree waits to age 66, it'd take 12 years to age 78 for the cumulative benefits *($2,000 x 144 months = $288,000)* to equal the cumulative benefits that'd have been received by starting at age 62 (*$1,500 x 192 months = $288,000)*. In this example, if the retiree lives beyond a 78th birthday, from that point forward this retiree will be ahead of the game.

If you take early benefits and invest the money you receive, assuming an increase in value, it'll extend the break-even point into the future by several years. Also note that cost-of-living increases haven't been taken into consideration, and they also extend the break-even point a few years into the future.

It's important to know that if you claim early benefits, they're permanently reduced and don't increase when you reach FRA. Further, if you're married and take early benefits, it also reduces the benefits your spouse might be eligible to receive based on your work history.

If you're still working at age 62, your benefits will be further reduced if you earn more than a certain amount each year. If you continue to work between the ages of 62 and your FRA, in 2012 you forfeit $1 of Social Security benefits for each $2 your earnings exceed $14,640. This figure is indexed annually for inflation. But if your benefits are reduced because of your earnings, you may actually receive a higher benefit once you reach your FRA.

For example, let's say Linda retires from her full-time job at age 62 and is eligible for $1,000 per month from Social Security. She expects to earn $20,640 in 2012 doing some part-time work. If she were to claim Social Security benefits, they'd be reduced by $250 per month *($20,640 – $14,640 = $6,000 in excess earnings, divided by 2 = $3,000 per year or $250 per month)*. Note that once you reach your FRA, there's no reduction in benefits if you continue working.

The Delayed Retirement Credit

The delayed retirement credit is another piece of the Social Security puzzle. If you wait until after your FRA to apply for benefits, you'll receive a credit that boosts your income. The credit is applied annually until age 70 (*see table, this page*). For example, assume a person born in 1950 is eligible to receive $1,000 per month at age 66, or $750 at age 62. By waiting until age 70 to claim benefits, this person would be eligible to receive an additional 32 percent, or $1,320. Note that the delayed retirement benefit isn't compounded by 8 percent each year; rather, it's an additional 32 percent total.

Delayed Retirement Credits

Year of Birth	Yearly Rate of Increase
1933-1934	5.5%
1935-1936	6.0
1937-1938	6.5
1939-1940	7.0
1941-1942	7.5
1943+	8.0

Source: Social Security Administration

There's no incentive to delay benefits past age 70, since the delayed retirement credit won't continue after that. Now the decision to take Social Security is somewhere between ages 62 and 70, but based on how long you expect to live, your need for additional income and your plans to continue working after age 62, you may already be starting to get an idea of what makes sense for you.

Factoring in Spousal Benefits

For married couples, spousal benefits add another layer to the decision-making process. Your spouse may be eligible for a spousal retirement benefit while you're alive if your earnings were higher than your spouse's. Depending on your spouse's year of birth and age when benefits begin, spousal benefits range from 32.5 percent to as much as 50 percent of what you receive from Social Security up to your FRA benefit. If you die before your spouse, your spouse will be eligible to receive up to 100 percent of your Social Security benefit if this amount is higher than his or her own benefit. A widow(er) can claim survivor benefits as early as age 60; however, survivor benefits paid at this age are reduced by 28.5 percent. If you expect your spouse to be eligible for benefits based on your work history or to outlive you, you may want to wait at least until your FRA to claim your benefits. This is particularly true for men, since on average, women tend to live longer than men.

Let's review an example, ignoring cost-of-living increases and the opportunity costs of investing money to keep it simple.Bob, age 62, has just retired. He's eligible for monthly Social Security benefits now in the amount of $1,800, or if he waits until his FRA of 66, he'll receive $2,400. His wife, Carol, is also 62 and is no longer working. She's eligible for her own benefit of $600 now, or $800 if she waits until her FRA of 66.

They decide they need some additional income, so Carol will apply for her benefits now. To maximize Bob's benefit, he'll wait until age 66, at which time he'll receive $2,400. When Bob applies for his benefits, Carol will be eligible for a spousal benefit that'll be higher than her own benefit. Her benefit will equal half of Bob's benefit less a 30 percent reduction, since she began receiving benefits when she was 62. (Early benefit reductions for spousal benefits are a little higher than for retiree benefits.) In this example, Carol will receive $600 per month for four years and then begin receiving $840 each month once Bob applies for his benefits *($2,400 x 50% x 70%)*.

Another reason they chose this strategy is because they think it's likely Carol will outlive Bob, and upon Bob's death Carol will begin receiving his benefit of $2,400 per month instead of her $840 per month. If we assume Bob dies at age 80 and Carol dies at age 90, they'd have received total benefits of $921,600. If both Bob and Carol had applied for benefits at age 62, assuming Bob lived to 80 and Carol lived to 90, they'd have received only $756,000. This strategy results in an extra $165,600 of income based on the prior assumptions.

An Informed Decision

There are two more rules you need to understand to make an informed decision regarding spousal benefits. First, your spouse cannot claim benefits based on your work record until you actually apply for your own benefits. Therefore, if your spouse has never worked, he or she doesn't have the option of receiving early benefits unless you have already applied.

Second, the delayed retirement credit doesn't get factored into spousal benefits, but it does get factored into widow(er)'s benefits. Using our example above, if Bob waits to age 70 to claim his benefit, he'd receive an extra 32 percent for a total of $3,168 per month.

Carol's spousal benefit, however, would be increased to only $840 once he begins receiving Social Security benefits. The 32 percent credit doesn't affect the spousal benefit Carol is entitled to receive while Bob is alive. But when Bob dies, Carol would then begin receiving $3,168 per month instead of $2,400 as in our original example.

The Impact on Income Taxes

You also need to consider how Social Security income will affect your income taxes. For federal tax purposes, add one half of your Social Security benefits to all your other income, including your tax-exempt interest. These figures can be found on the front page of your return before you take your deductions.

If the resulting total is below $25,000 (single) or $32,000 (married filing joint), none of your benefits is taxable. Otherwise, up to 50 percent of your Social Security benefits may be taxed.

But if half your Social Security benefits plus all your other income exceeds $34,000 (single) or $44,000 (married filing jointly), up to 85 percent of your Social Security benefits may be taxed.

In addition, you need to determine whether your state will tax Social Security income. Many states don't tax this income.

In conclusion, there's no easy answer as to when to apply for Social Security benefits. Once you consider the many factors discussed in this article, at least you can make an informed decision based on your own needs and expectations. It's a good idea to speak with a Social Security representative before you apply for benefits, as everyone's situation is different. You can call 800/772-1213 between 7 a.m. and 7 p.m. Monday through Friday, or visit your local Social Security office in person.

The Social Security Administration also handles Medicare enrollment, so be sure to prepare your Medicare questions when you contact them to discuss your retirement benefits. Once you've obtained all the necessary information, we recommend that you also consult with your tax adviser and financial planner before making your final decision.

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