Mastering the Social Security Timing Game

By Michael Finke | August 26, 2013

Psst, wanna buy an inflation-protected annuity for a bargain price? Sounds too good to be true? Well, it does come from an entity that has a few balance sheet and accounting issues. But it does have a pretty good business model—such as being able to print its own money to make annuity payments and throw customers in jail if they don't pay their bills.

Yes, one of the best sources of annuitization income for retirement is the federal government. As with many government programs, Social Security rules are complicated—but knowing them gives you access to some pretty sweet deals. Advisors are waking up to the benefits of helping clients maximize their retirement income strategies by wading through arcane Social Security rules.

Social Security claiming strategy is a game between you and the government, or, more accurately, between you and the taxpayers. Taxpayer advocates should be encouraging single obese smokers to claim at age 70, and fit, married, well educated, high earners (who probably look more like financial planning clients) to claim early. That's because rules created for the Ozzie and Harriet generation still apply for today's retirees, and because what is actuarially fair for the average American may be a bargain for you.

First, the basics. Social Security retirement benefits are based on the highest 35 years of wage inflation-adjusted earnings. The benefit amount is highly progressive, meaning that the benefit increases quickly up to a set amount, and then more slowly at "bend points" beyond that amount up to a 2012 maximum full retirement age benefit of $32,851.

You can claim at age 62, but full retirement age is now 66. If you delay claiming between 62 and 70 you get a higher benefit for each year you wait. Remember Ozzie and Harriet? Social Security is designed for a primary earner (husband) and a housewife who is entitled to a spousal benefit that she can claim at age 62 or delay until 66 for a full 50% of the primary earner's benefit.

How does claiming age affect Social Security benefits? Let's assume your income at full retirement age is $2,000 per month. Your benefit falls to 75% of that amount, or $1,500, if you claim at 62 and increases by 5% if you wait until 63 and then by about 7% each year up to age 66. After full retirement age you get an extra 8% per year. That's $2,640 per month if you can wait until 70. Spousal benefits also are reduced if claimed earlier than age 66.

Should a retiree claim at 62? Probably not. Stanford economist John Shoven and his co-author Sita Slavov estimate that everyone is better off waiting until 70 to claim Social Security if real, after-inflation interest rates are zero—which is about the market rate right now for inflation-adjusted bonds and annuities. So if you're thinking about buying an inflation-adjusted income annuity, don't do it until you've delayed claiming Social Security.

Singles should wait until 68 or 69 if they apply a discount rate of 2.5% to 4.5% to benefits—anything higher and they should claim at 62. Married couples should only consider claiming before 70 if they discount earnings above 6% after inflation. Can you find them another safe investment paying a real 6%? All these scenarios are based on average mortality, so a healthy client will have even more incentive to delay.

The biggest obstacle to implementing an optimal claiming strategy may be your client. A new study by Owen Haaga and Richard Johnson of the Center for Retirement Research finds that most retirees born in the 1930s claimed Social Security at age 62—the first year of eligibility. That fell to 46% for retirees born in the 1940s who were also far more likely to delay past 65. An advanced degree also doubles the probability of claiming at age 65-plus compared to having less than a high school degree. So younger, better educated clients are more open to delayed claiming.

Much of the resistance to claiming later in life is the persistent belief that Social Security will go broke and renege on its obligations. Convincing a client to delay is often the first step in developing a strategy. According to Andrea Eaton, a financial planner at Cornerstone Wealth Advisors inMinneapolis, "most Americans' first thought is to begin claiming at age 62 or the full retirement age, but we have been able to change most clients' minds."

A decrease in payment size down the road is possible, but as long as workers keep contributing to Social Security the checks won't stop. Taxpayers have been paying more toward Social Security than is paid out to beneficiaries (there was a $55 billion deficit in 2012). This excess went into the so-called Social Security trust fund, which can then be used to pay future retirees. The trust fund will continue to grow until 2021, and won't be depleted until 2033. After 2033, there could be a 23% cut in benefits according to current rules.

A big future haircut for retirees is hard to imagine. Politicians have been burned at the stake for suggesting even modest increases in retirement age or benefit cuts. Even a more realistic cost of living increase (the chained CPI) was branded a vicious attack on seniors with promises of retribution for any politician who dared vote for it. Reform will likely include a reduction in benefit growth, higher taxes and increasing the future age of eligibility. But Social Security isn't going away.

The Spousal Benefit

The spousal benefit underlies many of the most valuable and complex claiming strategies used by advisors. I can usually make it through about 30 seconds of a Social Security claiming strategy discussion before my eyes start glazing over. So I asked Amanda Lott, a wealth advisor for RegentAtlantic Capital inMorristownN.J., and expert in Social Security claiming rules, to give me a primer on how advisors can make the best recommendations.

Lott begins by presenting a scenario where a client claims at 62 and then compares that to the amount of benefits a retiree would receive from an alternative strategy by age 85. Not worrying about discounting higher future benefits makes sense since they will rise with inflation. Lott says that "even if you just do an aggregate sum, it's several hundred thousand dollars that you leave on the table" by claiming too early. Another strategy is to estimate the breakeven age at which benefits from a delayed strategy will be higher. Since the likelihood that one spouse will still be around at age 90 is 40%, this can be a compelling illustration.

Academic studies have shown that married couples receive the largest gains from creative claiming strategies. That's because the lower-earning spouse is both entitled to the larger delayed Social Security payment upon the death of the breadwinner and to receive a larger spousal benefit when the breadwinner is still alive. A recent analysis showed that a married couple received a 70% larger lifetime benefit just by deferring from age 62 to 63.

A spouse can claim the full 50% of the breadwinner's Social Security benefit at age 66. And you can claim the spousal benefit if you've never worked and if you have your own working history. This is where things get interesting. Since more baby boomer husbands and wives have their own employment history, they can take advantage of the spousal benefit to get even more income if they wait to claim their own benefits. Lott provides some examples to help us understand how this works.

Let's first start with a breadwinner/homemaker scenario. Both are able to claim income based on the breadwinner's earnings history. The homemaker gets no advantage from delaying spousal benefits beyond age 66. But the breadwinner does continue to get an 8% increase in benefits each year he waits to claim between 66 and 70. When the couple reaches the full retirement age of 66, the breadwinner can file for Social Security benefits and suspend payments—this is known as "file and suspend." This allows the breadwinner to delay his benefit until age 70 while allowing the homemaker to maximize her 50% spousal benefits at age 66. The homemaker now gets a higher income, but even better she is eligible to receive the breadwinner's higher delayed income when he dies. That's because survivor benefits allow the spouse to step in for the breadwinner and receive the full amount of his benefits. Since women tend to outlive men, this can be essentially a significant inheritance to provide income security into old age.

It gets a little more complicated when the homemaker is significantly younger than the breadwinner. If you have a couple with a 67-year-old breadwinner and 61-year-old homemaker, then the homemaker will be eligible for full spousal benefits after the husband hits age 70. So have the husband wait three years until age 70 to claim, and then have the wife wait another two years until 66 to begin receiving spousal benefits.

In cases where there is a very wide difference in age, for example the homemaker is 62 and the breadwinner is 75, then it can make sense for the homemaker to go ahead and take spousal benefits early. That's because she will likely receive the higher survivor benefits within the next decade and will have earned a decade's worth of spousal benefits in the interim. It's morbid, but it does make sense to have an eye on mortality tables when making recommendations.

What if the 75-year-old husband client passes away and leaves a 60-year-old wife? The wife is eligible to receive survivor benefits at age 60, but these are reduced each year that she claims them before 66. So she can maximize survivor benefits by waiting until 66. This is where an advisor can take advantage of the decoupling of working and survivor benefits. If the wife has her own earning history, she can begin taking benefits at age 62 and it has no impact on her ability to collect survivor benefits. She can then collect four years of her own benefits, for example at $1,000 per month, and then step into her former husband's $2,000 per month full survivor benefits at age 66.

This even works in reverse. If she has a longer working history and is eligible to receive $2,000 per month but her survivor benefit is $1,500 per month then she should go ahead and claim the survivor benefit right now at age 60 and then delay her own benefit until age 70. The rule, according to Lott, is that you look "at your own benefit and the survivor benefit to see which one's higher and maximize that one. If the survivor is higher, it's maximized at age 66. If their own working record is higher, that's maximized at age 70."

In the future, most spouses will each have their own earnings history. In this case, strategically claiming the spousal benefit can be particularly beneficial for couples whose ages are within four years of each other because either spouse can file and suspend only if both spouses are full retirement age (66). Lott gives an example of Bob and Sue who are both 66 and who each have their own primary benefit that they can claim anytime between ages 62 and 70. If Sue has higher lifetime earnings, then she should file and suspend at age 66 so that Bob can receive full spousal benefits between age 66 and 70.

Bob also needs to file a "restricted application," which lets Social Security know that he realizes the spousal benefits are less than his own. This is essentially free money since Bob continues to delay claiming his own benefit until age 70. This strategy not only gives Bob and Sue a higher monthly income by delaying until 70; if Sue's full retirement benefit was $2,500 per month then Bob gets $15,000 per year for four years in bonus cash by claiming spousal benefits.

Eaton gives another example where a wife is turning 62 and a husband is 60. She recommended that the wife begin claiming at age 62, allowing the husband to claim spousal benefits at age 66. At age 70, he can begin claiming his delayed benefit. An advisor can use a spreadsheet to estimate to assess which claiming strategy provides the most benefits by age 85 or which strategy provides the earliest breakeven age when compared to an early claiming baseline.

Bridging the Gap

Telling retired clients that they should wait to collect Social Security means that they're going to need to spend money out of their portfolio in the meantime. That's another challenge of delayed claiming. You need to convince the client that spending assets right now is an investment in future income.

Eaton likes to use a bucket-type strategy to help a client frame this investment by carving out a portion of the portfolio and calling it a "Social Security bridge." Eaton says that "if we think they're going to get $3,000 a month at age 70 and they're 62 now, we'll segment $350,000 and that bridge portfolio will provide them the $3,000 a month they need. The bridge that would hypothetically last a short amount of time is managed very conservatively."

Delayed claiming also provides opportunities to maximize qualified account strategies. It's best to keep an eye on income tax thresholds and maximize taxable income below brackets using IRA or 401(k) assets before age 70. For most clients, Social Security income will be 85% taxable so pulling money from a qualified account instead of from Social Security is not tax inefficient.

Furthermore, delaying provides an opportunity to initiate Roth conversions. According to Eaton, "if you have a married couple, you can keep them in the 15% tax bracket and fill that up with Roth conversions because they haven't started Social Security whereas once they start Social Security that opportunity is gone or is limited. If you think about down the road when there is only one survivor left, that will often push them into the 25% tax bracket. By doing the Roth conversion, you can keep them in the 15% tax bracket by moving all the IRA money over while there are two people and the tax bracket is twice as large. And you don't have to be worried making more of their Social Security income taxable when you do a Roth conversion."

Both tax avoidance and Social Security claiming strategies can save a client thousands of dollars by understanding the rules. This allows advisors like Eaton and Lott to provide significant value before they even begin to make portfolio recommendations. As Eaton says, "it's probably the cheapest way to get a guaranteed return out there."

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