The Kitces Report
Advancing knowledge in financial planning…
Volume 1, 2016

The New World Of Social Security Planning

Executive Summary

- Social Security benefits function as a form of income replacement in retirement. Yet unlike a pension, which might replace 50% or 70% of the average of the last three years or five years of salary, Social Security calculates its benefit based on the worker's *highest 35 years*, and the replacement rate has multiple tiers that produce benefits anywhere from 90% down to 27% of the worker's average inflation-adjusted lifetime earnings.

- The Social Security income replacement formula is used to calculate the Primary Insurance Amount (PIA), which is the benefit the worker can expect to receive at full retirement age (currently age 66, and moving to age 67 for those born in 1960 or later). Social Security recipients can start benefits as early as age 62 (which reduces benefits by 6.66%/year for the first three years early, and 5%/year for each additional year), or delay as late as age 70 (earning an 8%/year delayed retirement credit for waiting).

- While delaying Social Security is often viewed as a form of "guaranteed return", in reality delaying Social Security has a cost, which is the foregone benefits *not received* while waiting. As a result, the trade-off for delaying Social Security functions similar to the purchase of an annuity, with an upfront cost in exchange for (higher) payments for life starting at some point in the future.

- For delaying Social Security to be a good deal, the recipient must outlive the "breakeven period" over which the higher inflation-adjusting Social Security payments recover the foregone benefits not received up front (and after adjusting for growth rates and the time value of money). In practice, the longer you live, the higher inflation turns out to be, and the lower the portfolio's rate of return, the better the outcome for delaying Social Security.

- Married couples are also eligible for spousal and survivor benefits, which complicates the claiming decision. By delaying the receipt of benefits, the survivor benefit is increased, but during the delay, the spouse won't be entitled to spousal benefits, which can cause an untenable increase in the breakeven period. In the past, this was partially relieved by the File-and-Suspend strategy, but that is no longer available since the April 29, 2016 deadline.

- Most couples will evaluate one of four choices in the decision of whether to delay Social Security: for both to delay, for neither to delay, for the husband to claim early while the wife delays, or vice versa. In general, it will be best for both to delay if *both* have a highly favorable life expectancy, and it will be best for neither to delay if both have poor health. For the 'average' scenario, where the couple either has average health, or at least one person has good health, the optimal strategy is typically for the higher earner to delay as late as possible, and the lower earner to start as early as possible.

- Spouses born in 1953 or early (or on January 1, 1954) remain eligible for the "old" Restricted Application rules, which provide an additional claiming opportunity for couples where one spouse has filed and the other is delaying. The Restricted Application tactic is also beneficial for divorcees, who can potentially claim an ex-spouse's spousal benefit using Restricted Application at full retirement age, and switch to his/her own individual benefit at age 70.

- While the Social Security system is often described as "going broke" by 2034 (when the Social Security trust fund will be depleted), in reality the majority of benefits will still be paid at that time, simply via the tax revenues on then-current workers paying payroll taxes. As a result, claiming benefits early in an attempt to avoid a future reduction later is not an effective strategy, especially since it requires "just" a 2.6% increase in payroll taxes (from 12.4% to 15.0%) to make the system fully solvent for another 75 years.

About the Author

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Introduction

In 2008, the first of the Baby Boomer generation reached the Social Security eligibility age of 62, and since that time, more than 10,000 baby boomers are becoming eligible to claim Social Security every *day*.

Not surprisingly, as the volume of Social Security claims have exploded, so too has interest in strategies to optimize and maximize the available benefits, including leveraging a number of esoteric and "lesser known" rules to get every dollar possible. Yet ironically, the depth of media coverage about claiming strategies, and the attention it brings, has led both the Social Security Administration and Congress themselves to shut down a number of perceived "loopholes", from the Withdraw-and-Reapply (ended in 2010), to the File-and-Suspend and Restricted Application strategies (which are winding down now as a result of the Bipartisan Budget Act of 2015).

Notwithstanding these changes and crackdowns, though, significant opportunities remain to maximize Social Security benefits by making a "good" decision about when to file a claim, particularly for married couples (including same-sex married couples) who can coordinate claims with each other.

In this issue of *The Kitces Report*, we look in depth at the rules for calculating Social Security benefits, how to calculate the breakeven age for delaying, the issues that arise when coordinating benefits between spouses (including the impact of delaying on spousal and survivor benefits), and scenarios where it does (and doesn't) make sense to delay. We also explore the potential for Social Security reform, and whether or how a failure to reform the system, and a depletion of the Social Security trust fund in 2034, could impact the optimal Social Security claiming strategy!

Entitlement To Social Security Benefits

At its core, Social Security is an "entitlement" program. In the public policy context, an entitlement program means one where the benefits are established based on a broad class of individuals who have a legal right to claim those benefits, and anyone who meets the eligibility requirements will be 'entitled' to receive them (and not necessarily in proportion to the dollars/taxes they may have paid in to begin with).

Accordingly, under the Social Security program, anyone who works for at least 40 calendar quarters (10 years), receiving earnings that are/were subject to Social Security (payroll or self-employment) taxes, will be entitled to a Social Security benefit.

In order to receive one quarter's credit, the individual must earn (from wages or self-employment) at least $1,260 per quarter, with the dollar amount annually indexed for inflation. (Notably, since 1978, "quarters of coverage" are actually calculated on an annual basis, which means for every $1,260 earned in the year, one quarter of coverage is credited; as long as the worker earns $1,260 x 4 = $5,040, he/she will receive credit for the full four quarters of coverage for that year, even if all the dollars were actually earned in a single quarter.)

Notably, though, while any individual who earns their 40 quarters of coverage is entitled to at least *some* Social Security retirement benefit, the exact amount of the benefit can vary significantly.

Calculating The Social Security Benefit Amount

Although it is often not thought of in this manner, Social Security benefits are essentially calculated as a form of "income replacement" in retirement, not unlike how a pension is determined. Just as a pension might be calculated based on replacing a certain percentage of pre-retirement income – based on years of service, and calculating using the last three or five years' worth of income – so too is Social Security calculated as an income replacement percentage of pre-retirement income.

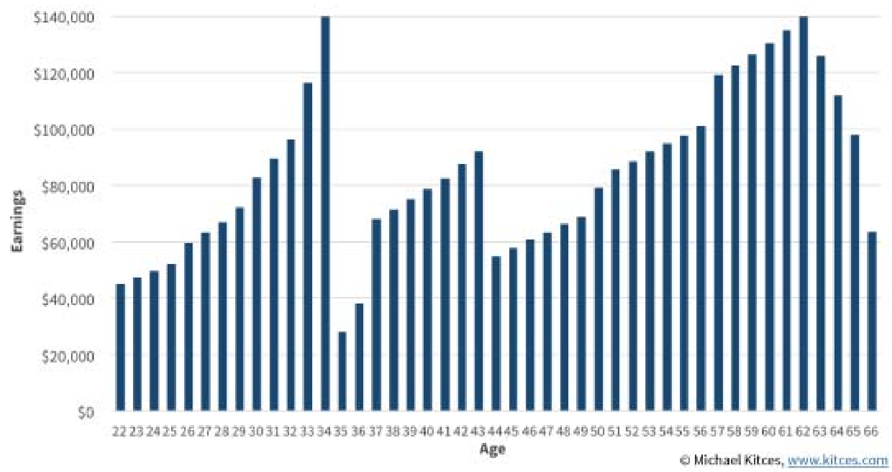
The difference, however, is that while pensions might be calculated to replace a 3- or 5-year income average, Social Security uses a *35-year* income average (of whatever the *highest* 35 years were, even if non-consecutive) to determine the base amount of income to be replaced in retirement.

Determining Average Indexed Monthly Earnings (AIME)

Of course, one caveat to calculating the average of a worker's highest 35 years of historical earnings is that in the distant past, earnings were typically lower – not just because the worker might have been earlier in his/her career (with lower-level jobs that have lower compensation), but simply because inflation lifts average wages over time (which means older more distant wages were lower in part simply because the inflation hadn't happened yet!).

For instance, Figure 1 (right) is an example of one worker's hypothetical historical earnings, with a high point in the early years (rapid career growth, followed by a career change when income took a big step back), and in general shows a slow upward trend to earnings over time.

Figure 1. Hypothetical (Nominal) Historical Earnings Of A Sample Worker



Accordingly, when Social Security determines the 35-year average of earnings, it first inflation-adjusts those earnings into current dollars using the National Average Wage Index (as shown in Figure 2, below).

Technically, this is done by inflation-indexing all historical earnings into a base year that was two years before the individual turned 62 and first became eligible for benefits (thus indexing to the individual's age 60). A 62-year-old in 2016 will have historical earnings inflation-adjusted to the 2014 wage index. Subsequently, benefits are adjusted upwards based on an annual Cost-Of-Living Adjustment [COLA] based on the Consumer Price Index.

Once inflation-adjusted earnings have been calculated throughout all the working years, *then* it's possible to determine which were the *highest* 35 years of earnings that will be included in the Social Security benefits calculation, as shown in Figure 3 at the top of the next page (where the top income years are in blue, and the remaining "lower income" years that were thrown out are orange).

In turn, once the highest 35 (inflation-adjusted) years of earnings have been determined, an average of those years can be taken. In our example above, this would equate to about $72,000/year.

Notably, since Social Security benefits are ultimately paid on a monthly basis, they are also calculated on a monthly basis. Accordingly, the individual's Average Indexed Monthly Earnings (or AIME for short) would be $72,000/year divided by 12 months/year = $6,000/month. Alternatively, this simply means the AIME is calculated by adding up the top 35 years of (inflation-adjusted) Social Security work history, and dividing by 35 years x 12 months/year = 420 months to determine the AIME, which is then used to calculate the actual Social Security benefit.

Figure 2. Historical Earnings Of Sample Worker, Adjusted For Inflation

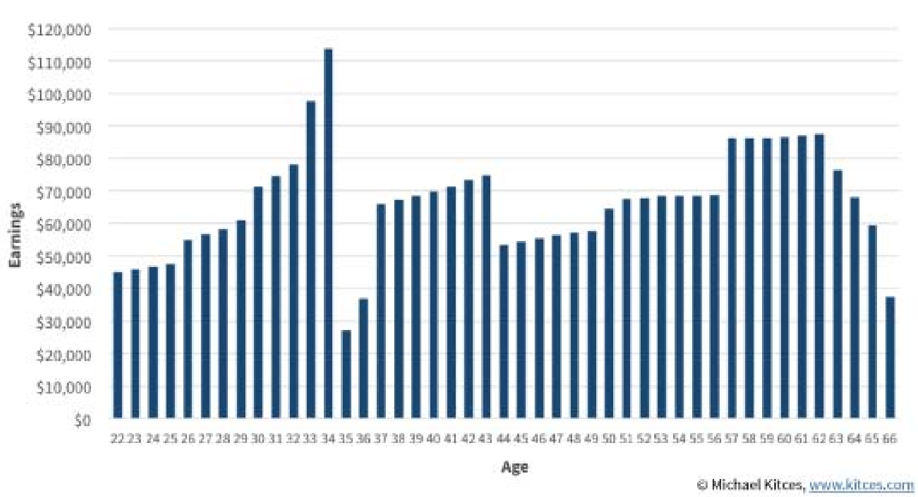
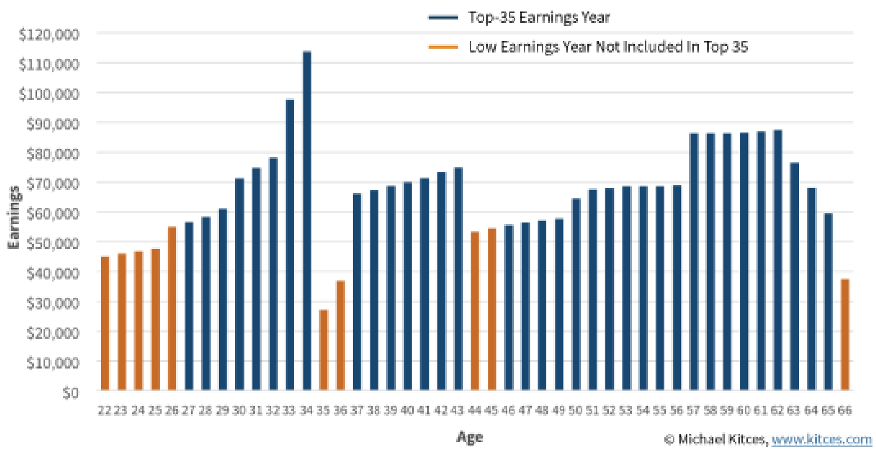


Figure 3. Top 35 Earnings Years Included In AIME Calculation



Calculating The Primary Insurance Amount (PIA)

While the AIME determines the amount of average lifetime earnings that will be used *to* calculate a Social Security benefit, the actual benefit calculation still requires applying the income replacement factors.

With pensions, it was/is typical to use a single replacement percentage tied to years of work. For instance, a worker's pension income might be 2% of final wages for each year worked, which means someone with 35 years of working history will receive a 35 years x 2%/year = 70% replacement rate. With Social Security, however, there are three replacement rate tiers, and they're based not on the number of years worked, but on the amount of the worker's average earnings in the first place (as calculated by AIME).

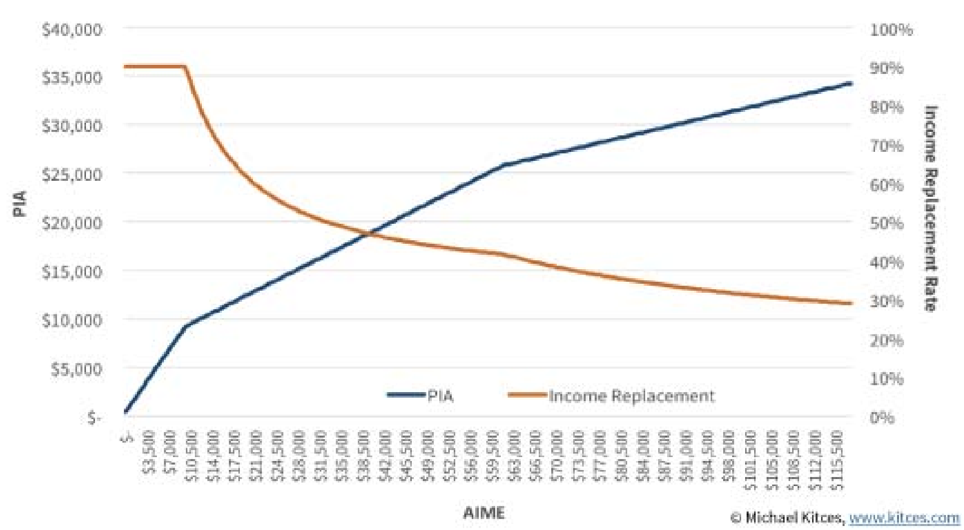
Specifically, Social Security is calculated by replacing 90% of the first \$856/month (in 2016) of AIME, plus 32% of the next \$4,301/month of AIME (up to \$5,157 of total AIME), plus 15% of any remaining income above \$5,157/month of AIME. The last 15% tier applies up to the maximum amount of earnings that can ever be considered for Social Security, which in 2016 is \$9,875/month (equal to the maximum Social Security wage base of \$118,500/year – thus, the only earnings included in the Social Security benefits formula are the earnings that were subject to Social Security taxation as well).

The benefit calculated under this income replacement formula is called the Primary Insurance Amount (or "PIA" for short), and represents the benefit the retiree would get at full retirement age (the timing thereof, and the implications of starting earlier or later, are discussed in much greater depth later).

Because the Social Security income replacement formula has multiple tiers, the net result is that as income (AIME) increases, the actual Social Security benefit (PIA) increases more slowly… which in turn means Social Security effectively replaces a higher percentage of income (as much as 90%) for lower-income workers, and less for higher-income workers, as shown in Figure 4 (below).

For someone who earns the maximum income eligible for Social Security throughout their working career, the maximum Social Security benefit is \$2,639/month in

Figure 4. Calculated PIA And Income Replacement Rate Based On AIME



2016, which is barely 27% of lifetime earnings. (Notably, this is slightly smaller than just applying the Social Security income replacement formulas to a maximum income of $9,875/month, due to timing of inflation adjustment calculations and the differences between the wage index used to calculate pre-age-60 adjustments, and CPI, which is used to calculate post-age-60 cost-of-living adjustments.)

Notably, once someone is actually receiving Social Security benefits, subsequent years also receive an annual Cost-Of-Living Adjustment (COLA) as well.

Figure 5. Eligible Full Retirement Age By Birth & First Eligible Years

Year of Birth	Full Retirement Age	Year Turing Age 62 & First Eligible for Retirement Benefits
1943-1954	66	2016-and-prior
1955	66 and 2 months	2017
1956	66 and 4 months	2018
1957	66 and 6 months	2019
1958	66 and 8 months	2020
1959	66 and 10 months	2021
1960 and later	67	2022 and later

Choosing The Timing Of Social Security Benefits

While the Social Security program provides that anyone/everyone who earned their 40 quarters of coverage is entitled to some Social Security retirement benefit – and if they have 10 years' worth of earnings, there *will* be some calculated benefit amount – there is still some flexibility about *when* those benefits will be paid.

The calculation of an individual's Primary Insurance Amount determines the benefit that will be payable at his/her Full Retirement Age (FRA). The full retirement age itself is a moving target, which was age 65 in the original Social Security system, is currently age 66 for today's baby boomer retirees, and will slowly transition to age 67 for anyone born in 1960 or later, as shown in Figure 5 (above).

Regardless of full retirement age, though, those entitled to a Social Security retirement benefit have the option of starting early or late, as shown in Figure 6 (below).

Those who wish to claim early can begin benefits as early as age 62. Starting benefits early results in a 6.66%/year-early haircut in the PIA (technically, 5/9ths of 1% per month started early) for starting up to three years early. Starting benefits beyond three years early results in a 5%/year-early reduction in the PIA (calculated as 5/12ths of 1% per month). Thus, for instance, someone whose full retirement age was 66 but began at age 62 would be starting four years early, for a total reduction of 6.66% x 3 years + 5% x 1 year = 25% reduced.

Similarly, those who delay *past* full retirement age are eligible for a benefit increase. For anyone born in 1943

Figure 6. Social Security Benefit Increase/Decrease For Starting Late/Early

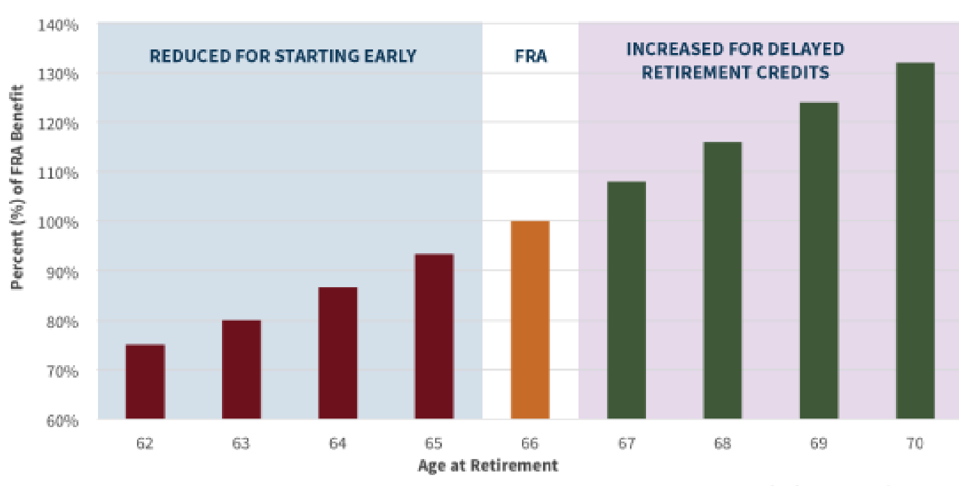
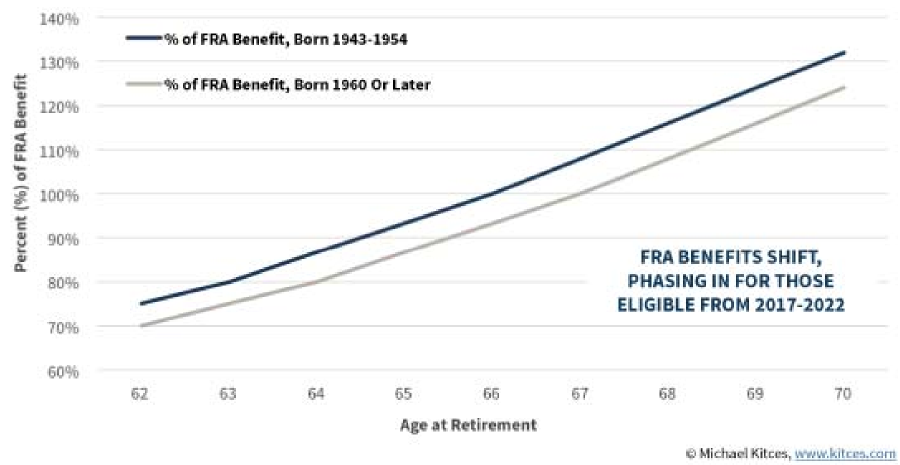


Figure 7. Impact Of Shifting Full Retirement Age On Starting Early/Late



do you want to wait on getting benefits today, in order to receive increased benefits in the future?

This dynamic of waiting to receive increased Social Security benefits is often discussed as a form of "guaranteed return" – because the Social Security benefit increase of as much as 8%/year is guaranteed, just by waiting – but in reality, the decision to wait isn't merely a guaranteed return, because it also has a *cost*. The cost is the years' worth of benefits you *don't* get in your pocket, while waiting to earn that higher benefit in the future!

For instance, imagine a prospective 66-year-old retiree who is full retirement age, and is currently entitled to a benefit of $1,000/month. He could begin that $1,000/month payment today, or delay a year in order to receive an 8% delayed retirement credit, boosting his benefit to $1,080/month, but forgoing $1,000/month x 12 months = $12,000 in order to get that $80/month boost. Thus, the question arises: how long does it take to recover the $12,000 shortfall with an extra $80/month thereafter? The answer: it takes about 13 years to break even, as shown above in Figure 8 (below).

Of course, the caveat is that the real "cost" to delay isn't just the $12,000. That is because the $12,000 that could

or later (all current and future Social Security beneficiaries who haven't yet claimed benefits), each year of delay past full retirement age is an 8%/year "delayed retirement credit" (DRC) that increases the PIA. For someone whose full retirement age was 66, delaying to the maximum age 70 results in an 8%/year x 4 years = 32% increase of the PIA. (Notably, the increases for DRCs are always calculated as a percentage of the original PIA; thus, they are 8%/year cumulative increases, but not compounding.)

Of course, as noted earlier, full retirement age itself is transitioning from age 66 to age 67 for those between from 1954 to 1960. Given that the maximum early and late eligibility thresholds are fixed at ages 62 and 70, respectively, the shift in full retirement age causes the impact of starting at age 62 to be more severe (a greater haircut, as it's now a 5-year benefit reduction), and the value of delaying until age 70 lessened (as it will only be a 3-year delay generating 24% in DRCs), as shown in Figure 7, above.

Delaying Social Security – An Annuity Trade-Off

Notwithstanding the ongoing shift of full retirement age in the coming years, at the margin, the fundamental decision of whether or not to delay Social Security is the same –

Figure 8. Breakeven For Delaying Social Security 1 Year Past FRA

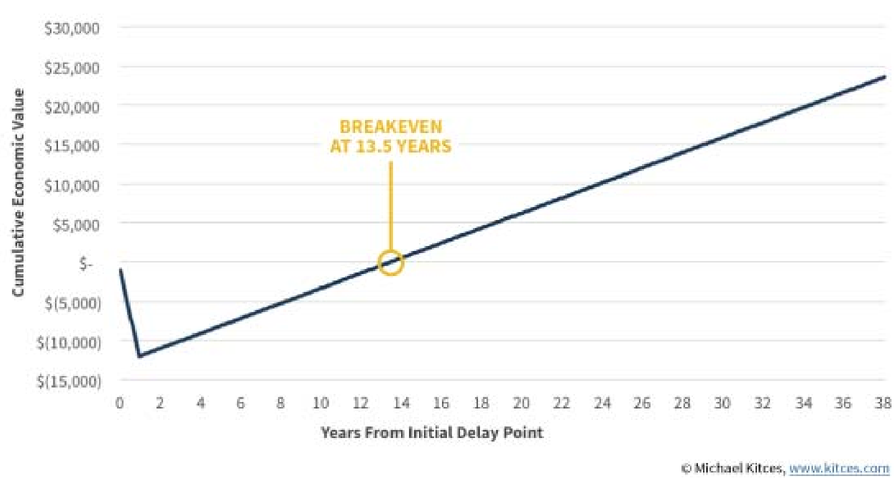
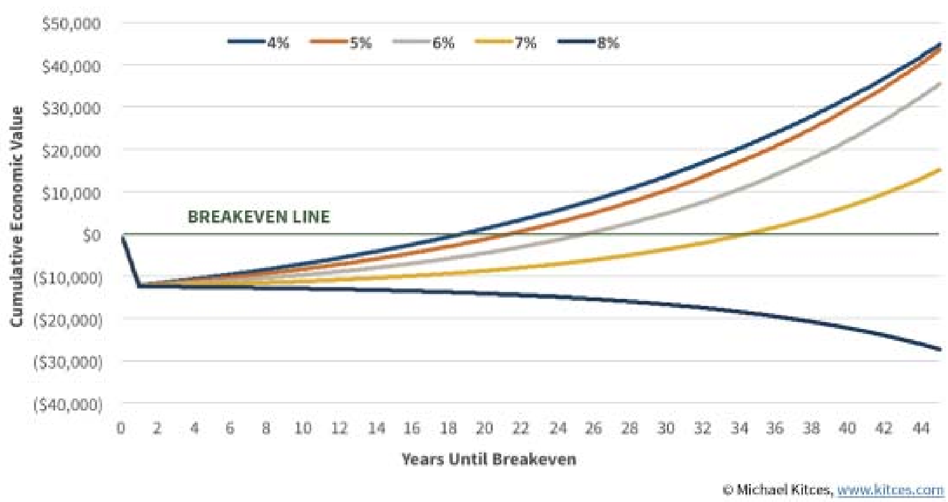


Figure 9. Breakeven For Delaying Social Security Including Impact Of Growth Rates (Time Value Of Money)



have been invested! Or alternatively, it's $12,000 that could have been used for spending, allowing some *other* $12,000 of the portfolio to remain invested. Which means we have to apply a reasonable growth rate to the $12,000 to truly account for the time value of money, making it somewhat less appealing to delay. At a 'mere' 4% growth rate, the breakeven period extends to almost 18 years, at 6% it's 25 years, and at an 8% growth rate, delaying Social Security *never* breaks even for someone who lives all the way to age 100, as shown in Figure 9, above!

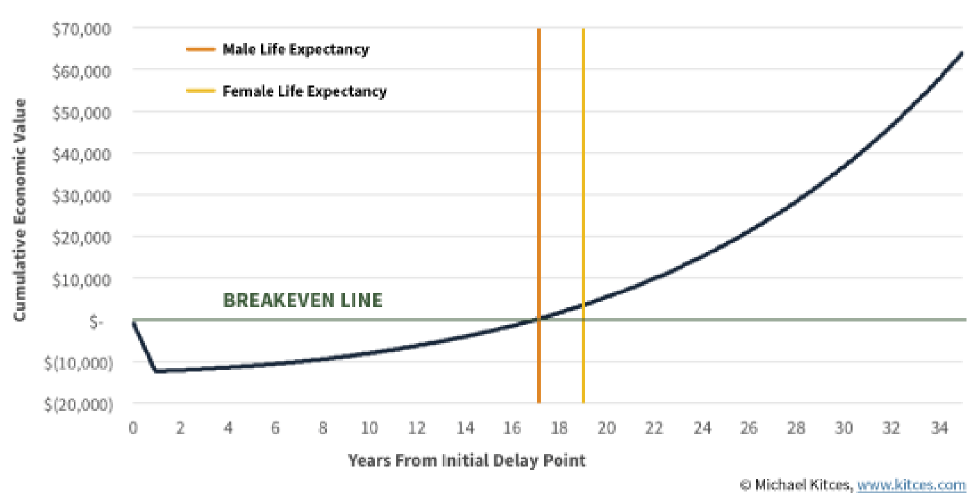
On the other hand, it is also important to remember that Social Security gets an annual Cost-Of-Living Adjustment. As a result, delaying for a year doesn't *just* generate an extra $80/month of benefits. It produces an extra $80/month *adjusting for inflation each year thereafter*. So it's an extra $80/month in the first year after delay, but then may go to $82/month, then $85/month, etc., as inflation compounds upwards.

Over time, the impact of the COLA on that extra Social Security benefit amount for delaying becomes very significant. Even at a mere 3% inflation rate, by age 90 the retiree is getting an extra $160/month for the same original $12,000 of foregone benefits up front. If inflation turns out to be 5%, it's almost an extra $260/month for the same $12,000 "fixed cost"!

In essence, then, the decision to delay Social Security is a trade-off where you "pay" once up front (in the form of foregone benefits) in exchange for receiving a *lifetime inflation-adjusting annuity* (in the form of higher inflation-adjusting benefit payments every year thereafter). Of course, as with any annuity purchase, the longer the retiree lives (and gets those extra ever-increasing payments), the better the deal it is to delay.

In fact, it turns out that Social Security is so favorably priced that it is actually quite an amazing "deal" in the long run. This is due primarily to the fact that the adjustment factors for waiting (e.g., the delayed retirement credits) were originally calculated back in 1983, when interest rates were significantly higher, and life expectancies were far shorter, than either are today. As a result, even "just" living to life expectancy has a rather favorable expected internal rate of return for choosing to delay (and those with above-average wealth tend to have above-average life expectancy, which just

Figure 10. Social Security Delay Breakeven, Including Growth & Inflation Rates



makes it even *more* appealing to delay, for those who have the financial wherewithal to do so)!

For instance, Figure 10 (prior page) shows the cumulative economic benefit of delaying Social Security (with a $1,000/month benefit in exchange for an 8% delayed retirement credit), assuming a 3% inflation COLA and a 6% portfolio growth rate. Males already reach their breakeven at life expectancy, and females are ahead at life expectancy. And notably, these are based on aggregate life expectancy estimates from Social Security; the subset of individuals who are more affluent (and more likely to have the wherewithal to consider delaying) have even better life expectancy, and an even more positive expected value for delaying!

Overall, with these 6% growth and 3% inflation assumptions, it takes almost 17 years to reach the breakeven period. And by then, the extra $80/month Social Security payment has risen to $128/month, thanks to cost-of-living adjustments. In addition, once the breakeven is reached, any extra growth rate will compound *in favor* of having delayed.

Consequently, while it is a 17-year breakeven period to recover the initial $12,000 "investment", it only takes another six years to make an additional $12,000, another four years to make the next $12,000, and then barely three more years to make the next $12,000!

In the end, the retiree who delays Social Security a year from age 66 to 67, and ultimately lives to age 100, has turned a $12,000 investment into nearly $60,000. Which is equivalent to a *real* (inflation-adjusted) internal rate of return of nearly 6%, in a world where a comparable 30-year TIPS bond barely yields 1%! And even "just" at life expectancy, the value of delaying will have already turned the -$12,000 upfront cost into, on average, a favorable internal rate of return for an otherwise-heathy retiree.

Coordinating Spousal (And Survivor) Benefits For Couples

For an individual, the process of making a good decision on Social Security timing is relatively straightforward. Make a reasonable estimate for growth rates and inflation, consider anticipated life expectancy (and the risk of materially outliving it), and decide how important it is to hedge against those three risks if the numbers turn out less favorable than projected.

With a married couple, though, the scenario is more complicated, because of the role of spousal and survivor benefits.

The Unique Portfolio Hedging Benefit Of Delaying Social Security

Ultimately, there are three factors that drive the relative benefit (or lack thereof) of delaying Social Security: the growth rate of the portfolio (time value of money), inflation (the COLA on the higher benefits), and life expectancy (the time horizon for the benefit to compound).

Delaying Social Security works *best* when growth rates are *low* (i.e., there is little foregone upside by spending other portfolio dollars while waiting for the Social Security benefit to grow), when inflation is *high* (which allows the increased benefit to gain a larger cost-of-living adjustment), and when life expectancy is long (allowing more years for the benefits to compound).

These factors are notable from the perspective of portfolio diversification, because it turns out that the three factors that are *worst* for a portfolio-based retirement are when market returns are poor, inflation is high, and retirement lasts an 'unexpectedly' long time!

In other words, the scenarios that are *best* for delaying Social Security are the exact ones that are *worst* for portfolios, which means the Social Security delay decision actually functions as a *hedge* against those adverse factors affecting the portfolio.

Of course, the reverse is also true – when market returns are good, inflation is modest, or retirement turns out to, sadly, be short – the value of delaying Social Security declines, even as the portfolio results will just turn out better than expected.

Yet again, this is simply the fundamental dynamic of effective diversification and hedging strategies – what is good for A is bad for B, and vice versa as well. Which means that while there's risk to relying on a portfolio for retirement, or to delaying Social Security, the risks are *opposite* of each other – a nearly perfect negative correlation of the relevant factors – which makes the act of delaying Social Security, even if it entails spending down some of the portfolio while you wait, and especially good way to hedge what will otherwise be a portfolio-withdrawal-based retirement strategy!

Entitlement And Eligibility For Spousal Social Security Benefits

As a part of the Social Security system, the spouse of a worker is entitled to a spousal benefit, equal to 50% of that worker's Primary Insurance Amount (PIA) at full retirement age. And notably, the base spousal benefit will *always* be 50% of the worker's PIA, *regardless of whether that worker claims benefits early or late*.

However, for the spouse to become eligible for a spousal benefit, he/she must be at least age 62. And if benefits are paid at the age 62 eligibility threshold, they will be reduced, by 8.33%/year for the first three years early, and 5%/year for each additional year. Thus, a spouse whose full retirement age was 66 but chooses to start at the earliest eligible age of 62 will receive benefits four years early, which results in a 30% reduction in spousal benefits. Notably, with spousal benefits, while the full benefit is payable at full retirement age, and there is a reduction for starting early (before full retirement age), *there are no delayed retirement credits for starting later than full retirement age*.

However, even if a spouse is *eligible* for a spousal benefit (by being at least age 62), the spousal benefit cannot be paid until the spouse is also *entitled* to receive a spousal benefit, as shown in Figure 11. In this context, being "entitled" means that the couple must actually *be* married (in a marriage that has lasted for at least one year), *and the primary worker must have actually filed for benefits*. (In the case of a divorcee, the requirements are that the couple must have been married for at least 10 years, the claiming spouse must currently be unmarried, and the ex-spouse must *be* at least age 62 [regardless of whether he has actually claimed.)

In other words, in a 'traditional' husband-and-wife scenario, the wife is eligible for a spousal benefit starting at age 62, but is not *entitled* to that spousal benefit until it is *also* true that the husband has actually filed his own claim for benefits!

> *Example 1*. Sheila is 66 years old, and as a homemaker never worked enough outside the home to earn her own Social Security retirement benefit. However, her husband Ron will soon be claiming his own $2,000/month Social Security benefit at his full retirement age, which will make Sheila entitled to a $1,000/month spousal benefit. Notably, though, *Sheila is not entitled to her $1,000/month benefit until Ron claims his $2,0000/month benefit as well*, even though she's old enough to be eligible for a benefit.
>
> On the other hand, because Sheila has already reached her full retirement age, she *will* be eligible for the entire $1,000/month benefit, regardless of whether Ron claims his benefits a little before full retirement age, at full retirement age, or even if he delays all the way to age 70 to gain his own delayed retirement credits.
>
> Thus, while Sheila is not entitled to a benefit until Ron files, she will always be entitled to the same $1,000/month benefit (given that *she* is full retirement age), regardless of whether Ron's benefit is increased or decreased because he further delays or decides to start early.

As the example illustrates, for a spouse to be eligible for a spousal benefit, the spouse must be both *entitled* and also be *eligible* by age. The spouse is *entitled* to the same benefit (50% of the worker's PIA) regardless of when the worker files (*as long as* the worker *does* file), but the

Figure 11. Social Security Spousal Benefits – Entitlement & Eligibility

Spousal Benefits		
Benefit Amount: 50% of worker's PIA		
Entitled		Eligible
Married	Divorced	Full benefit at Full Retirement Age (FRA)
Worker must have filed for his/her own benefit	Worker must be at least age 62	Can start as early as age 62 (reduced by 8.33%/year, plus 5%/year beyond 3 years early)
Must have been married for at least 1 year	Must have been married for at least 10 years	No delayed retirement credits past FRA
Must still be currently married	Must be currently unmarried	

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entitled benefit may then be reduced if the spouse *actually* files early for their own spousal benefit. Ultimately, the timing of when the spousal benefit is claimed *is* up to the spouse, though, because it's still necessary to actually *file* a claim for spousal benefits to start them (as they do not begin automatically merely by being entitled and eligible by age).

If a spouse is eligible for *both* spousal and retirement benefits at the same time and files a claim, the spouse will receive whichever is the *higher* of the two (not the cumulative total of both). However, to receive both benefits, the spouse must actually be *entitled* to both benefits.

In addition, it is important to recognize that with spousal benefits, *any application to request either spousal or retirement benefits is a deemed application for both* (if eligible for and entitled to both). In other words, it is generally not possible to *just* claim spousal benefits now, while delaying otherwise-eligible retirement benefits to earn delayed retirement credits. Either they

Filing A Restricted Application For Spousal Benefits

The standard rule when someone applies for Social Security retirement or "auxiliary" (e.g., spousal or dependent child) benefits is that applying for any benefit is a "deemed filing" for *all* benefits to which you are entitled.

As part of the Senior Citizens Freedom To Work Act of 2000, though, retirees for the past 16 years have had the option to request benefits and then *voluntarily suspend* any retirement benefit (as long as he/she was full retirement age at the time of the suspension). Doing so allowed for the retiree to continue to earn delayed retirement credits for his/her retirement benefits, and suspending the retirement benefit was possible *even as* the spousal benefit continued to be paid.

This strategy, dubbed "Restricted Application" (which is shorthand for filing a "Restricted Application for [Just] Spousal Benefits"), effectively made it possible for a spouse to specifically request to receive *just* spousal benefits and not individual retirement benefits. Which in turn just made delaying until age 70 even *more* appealing, because it was possible to delay (retirement benefits) *and* still get some (spousal) benefits paid in the meantime!

However, the Bipartisan Budget Act of 2015 ended the Restricted Application strategy, albeit with a special "grandfathering" provision: anyone who had attained the age of 62 by the end of 2015 (the year the legislation took effect) would continue to be allowed to file a Restricted Application. Anyone who didn't make the age cutoff would be reverted back to the "old" rules, where any application for benefits are automatically a deemed filing for *all* benefits (and similarly, a suspension of benefits is a suspension of *all* benefits), once again turning the decision to file into an all-or-none decision (the higher of spousal or retirement benefits, or no benefits at all) rather than a claim-one-now-and-the-other-later.

The end result of this change is that for anyone born in 1953 or earlier (or on January 1st of 1954) remains eligible to file a Restricted Application upon reaching full retirement age – assuming, of course, that the person is entitled to their own individual retirement benefit, wants to delay it, and is also entitled to a spousal benefit that actually *could* be claimed along the way by doing the Restricted Application in the first place.

The strategy is primarily relevant for married couples where one person has already filed (rendering the other entitled to a spousal benefit) and the other wants to *just* claim that spousal benefit while delaying his/her own benefit. (Restricted Application is also relevant for divorcees, as discussed in a later sidebar section.) Of course, if the spouse does not have his/her *own* retirement benefit, and/or the benefit will not be any larger than the spousal benefit anyway, it is a moot point, and they should just claim any/all benefits (as they will only ever get the higher spousal benefit anyway).

In the long run, the Restricted Application strategy will eventually fall away altogether. By 2023, everyone who was born in 1953 or earlier will have reached age 70 anyway, and thus will have fully claimed their own retirement benefits either way (making a restricted application irrelevant). And in fact, most of those who remain eligible will likely complete their Restricted Application by the year 2019 (when the youngest reach full retirement age and become eligible to do the Restricted Application for any spousal benefit they're entitled to).

Thus, even though the Bipartisan Budget Act of 2015 "killed" the Restricted Application strategy, it will remain relevant for at least a few more years, for those who want to claim a spousal benefit at full retirement age, and continue to earn delayed retirement credits on their own benefit in the meantime!

are *all* filed for – and the applicant receives whichever is highest benefit he/she is entitled to – or none are filed for. However, a special grandfathering rule does apply for anyone born in 1953 or earlier (or on January 1, 1954), to file a Restricted Application for *just* spousal benefits at full retirement age, while delaying retirement benefits to earn delayed retirement credits (see sidebar).

Figure 12. Social Security Survivor Benefits – Entitlement & Eligibility

Survivor Benefits		
Benefit Amount: 100% of worker's PIA, reduced if worker claimed early, increased if worker delayed		
Entitled		Eligible
Married	Divorced	Full benefit at Full Retirement Age (FRA)
Worker must be deceased Must have been married for at least 9 months before death* Must be unmarried, or remarried after age 60	Worker must be deceased Must have been married for at least 10 years Must be unmarried, or remarried after age 60	Can start as early as age 60 (reduced pro-rata for starting early, up to maximum of 28.5%) No delayed retirement credits past FRA

*Certain exceptions apply for shorter marriages if death was accidental

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Determining The Survivor Benefit And Delaying To Increase It

With a married couple, not only is a spouse able to claim a spousal benefit based on 50% of the primary worker's PIA while they are both alive, but a surviving spouse is *also* eligible for a widow(er)'s benefit after the primary worker passes away.

The survivor's benefit is based on 100% of the decedent's actual Social Security benefits if he/she had actually started benefits. If the primary worker had not claimed benefits yet, the survivor benefit is based on his/her PIA (plus any accrued delayed retirement credits).

> *Example 2*. Jeremy has a PIA of $1,800/month, which is the benefit he will receive at full retirement age of 66, although he is currently only age 62. If Jeremy were to pass away now (at age 62), his wife Wanda would be eligible for an $1,800/month survivor benefit. However, if Jeremy were to claim early, reducing his benefit by 25% to only $1,350/month, and *then* passed away, Sheila's survivor benefit would also be reduced to $1,350/month. For Sheila to be entitled to Jeremy's full PIA of $1,800/month as a survivor benefit, he must actually be waiting until full retirement age to claim his benefits.
>
> On the other hand, if Jeremy were to delay past his full retirement age and earn Delayed Retirement Credits, those DRCs will increase not only his own benefit, but also the prospective size of Sheila's survivor benefit. Thus, if Jeremy were to wait until age 70, and earn 32% in delayed retirement credits, then his benefit would rise to $2,376/month (plus cost-of-living adjustments), and Sheila's survivor benefit would also rise to $2,376/month (again, plus any future COLAs). Notably, if Jeremy was delaying until age 70, but passed away just as he reached his 70th birthday but before he actually made a claim, Sheila's survivor benefit would *still* be the $2,376/month, because the delayed retirement credits apply and increase the survivor benefit, even if Jeremy hadn't actually claimed the higher benefit yet.

To be *entitled* to a survivor benefit, as shown in Figure 12, the first requirement is not surprisingly that the primary worker must have actually passed away. In addition, the couple must have been married for at least nine months *before* the death occurred (thus, a 'deathbed marriage' will not instantly endow a survivor benefit). And, for the survivor spouse to be entitled to a benefit, he/she must either *not* remarry at all, or must only get remarried *after* age 60. If the survivor remarries prior to age 60, he/she will get spousal and survivor benefits based on the new spouse, not the prior deceased spouse.

Notably, divorcees are eligible for a survivor benefit after an ex-spouse passes away, too. In order to be entitled to an ex-spouse's survivor benefit, the prior married must have lasted for at least 10 years, again the divorcee must be unmarried (or not remarry until after age 60), and of course the ex-spouse must have actually passed away in the first place.

In addition, as with the spousal benefit, a survivor must not only be *entitled* to a survivor benefit, but must also actually be *eligible* for the benefit. In this context, eligibility means being at least age 60 to claim an entitled survivor benefit (which is reduced by 28.5% for starting that early), or waiting until full retirement age to claim the full survivor benefit.

As in the case of spousal benefits, when a widow(er) claims *both* survivor benefits *and* his/her own benefits, only the higher of the two is paid (not the cumulative total of both). However, the decision to claim retirement benefits is made *entirely independent* of the decision to claim survivor benefits and vice versa; thus, unlike spousal benefits (where an application for either is generally a deemed application for both), a survivor spouse really can simply choose to claim one now while delaying the other later (and regardless of eligibility to file a restricted application).

The Challenges In Timing Social Security Benefits For Couples

The existence of spousal and survivor benefits for married couples introduces a significant 'wrinkle' to the normal decision-making process on when to begin Social Security benefits.

On the one hand, the existence of survivor benefits can make it even *more* appealing for at least the higher earning spouse to delay, as earning delayed retirement credits increases not only that person's benefit, but also the survivor benefit that the spouse will step up to in the future.

On the other hand, *waiting* for delayed retirement credits can effectively hold the spousal benefit "hostage", as the delayed filing also delays the spouse's entitlement to that spousal benefit. And even as the primary worker delays and gets his/her *own* delayed retirement credits, there are no related delayed retirement credits for the spousal benefit; it's just an outright loss of what may be several *years'* worth of spousal checks that can't be claimed. *(Michael's Note: In the past, this dilemma was resolved with the so-called "File And Suspend" strategy, but the Bipartisan Budget Act of 2015 eliminated that claiming rule, effective April 30, 2016! See sidebar for further detail.)*

This dynamic creates a tension in the timing of when to begin Social Security benefits, as depending on the

The End Of File-and-Suspend
The voluntary suspension rules, created under the Senior Citizens Freedom To Work Act of 2000, made it possible for a retiree who had previously started Social Security benefits to later stop them (at full retirement age), and earn delayed retirement credits for each subsequent year's benefit that wasn't actually paid (up to the maximum age of 70).

Creating the ability to suspend a previously claimed benefit was intended as a way to encourage workers who started benefits early to be able to easily stop their benefits and go back to work, but was quickly adopted as a strategy where someone who reached full retirement age would go into the Social Security Administration offices and request to start benefits *and immediately suspend them.*

The reason for doing this was that by filing a claim for benefits, the spouse would become entitled to a spousal benefit, and by (immediately) subsequently suspending the benefit, the primary worker could still earn delayed retirement credits as though he/she had just waited all along. This resolved the classic dilemma of the couple where the higher earner wanted to wait until 70 to maximize delayed retirement credits, but the spouse didn't want to be stuck waiting that long for spousal benefits as well (given that there are no delayed retirement credits for spousal benefits).

However, the Bipartisan Budget Act of 2015 eliminated this tactic, by declaring that effective April 30 of 2016, anyone who voluntarily suspends retirement benefits will *also* suspend any *other* benefit being paid based on his/her earnings record. Which means suspending the individual's own retirement benefit will suspend any/all spousal benefits being paid to his/her spouse as well, rendering the File-and-Suspend strategy dead (as while it's still possible *to* file and immediately suspend, there's no longer any reason to ever do so).

Notably, though, anyone who filed and suspended *before* April 30 (i.e., by April 29 of 2016 or earlier) has still filed, and a suspension that was requested by the deadline does not impact benefits thereafter. Thus, if someone filed and suspended *before* April 30, the spouse remains entitled to spousal benefits (even after that date) and can still submit a claim for spousal benefits (or if born in 1953 or earlier, a Restricted Application for just spousal benefits) even if the spouse doesn't make the request until *after* the April 29 deadline. However, if the primary worker had not *already* filed *and suspended* by April 29 of 2016, he/she is past the deadline, and the File-and-Suspend strategy is simply no longer available going forward.

ages and benefits of the couple, the desire to delay a higher earner's benefit to maximize individual and survivor benefits means the spouse is not entitled to claim spousal benefits along the way.

> *Example 3.* Fred and Ethel are both full retirement age. Fred's PIA is $2,000/month, while Ethel is not entitled to her own retirement benefit (as she never worked enough outside the home to earn her 40 quarters of coverage). Fred would like to delay his benefits to age 70 to increase both his retirement benefit, and the survivor benefit that Ethel will receive in the future if he passes away first. However, waiting until age 70 to file means Ethel won't be entitled to spousal benefits, so she won't get a check for four years (nor will she get any increase to her spousal benefits for waiting, since there are no delayed retirement credits for spousal benefits). This effectively increases the "cost" for Fred to delay his benefits – giving up on *both* Fred's retirement benefits *and* Ethel's spousal benefits – and can dramatically extend the breakeven period for the couple to benefit from the delay.

The adverse consequences of delaying a retirement benefit and "losing" years of a spousal benefit are most severe in situations where the spouse is relying on most/all of the spousal benefit, and doesn't have a (significant) individual retirement benefit of his/her own. In situations where the spouse has earned their own benefit, though, other coordination challenges arise.

> *Example 4.* Brad and Angie are both full retirement age, and both had successful careers, such that each is entitled to their own $2,000/month benefit. In this scenario, neither Brad nor Angie will end out receiving a spousal benefit anyway, because their own much-larger $2,000/month benefits will overwrite any smaller $1,000/month benefit (though notably, if Brad and/or Angie were born in 1953 or earlier, they would still have the opportunity to file a Restricted Application to claim a spousal benefit for four years, and switch back to their retirement benefit later). Similarly, at this point neither Brad nor Angie will gain anything from a survivor benefit from the other spouse, because the survivor benefit would be as large as his/her own individual retirement benefit anyway.

Notwithstanding their similar benefits, though, the scenario above still has an opportunity to maximize Social Security benefits by coordinating the timing of claims, particularly if *one* of them chooses to delay while the other does *not*.

> *Example 5.* Continuing the prior example, assume that Brad decides to delay his benefits until age 70, while Angie chooses to go ahead and claim her benefits now. With this approach, Brad still has the normal individual opportunity to reach the breakeven period (by delaying from age 66 to 70 in order to get his 32% increase from delayed retirement credits). In addition, his decision to delay also "creates" a relevant survivor benefit, because Brad's delayed benefit will rise to $2,640/month (plus cost-of-living adjustments), which is higher than Angie's $2,000/month benefit.
>
> As a result, if Brad lives to the breakeven age, he will come out ahead with the extra $640/month of benefits he receives by delaying… and even if Brad doesn't survive, the couple will still benefit as long as *Angie* receives the extra $640/month in the form of a higher survivor benefit as well. In addition, if Brad was born in 1953 or earlier, once Angie files he could file a Restricted Application as well and receive a $1,000/month spousal benefit based on Angie's earnings history, all while delaying his own benefits, which just further reduces the breakeven period for Brad's decision to delay.

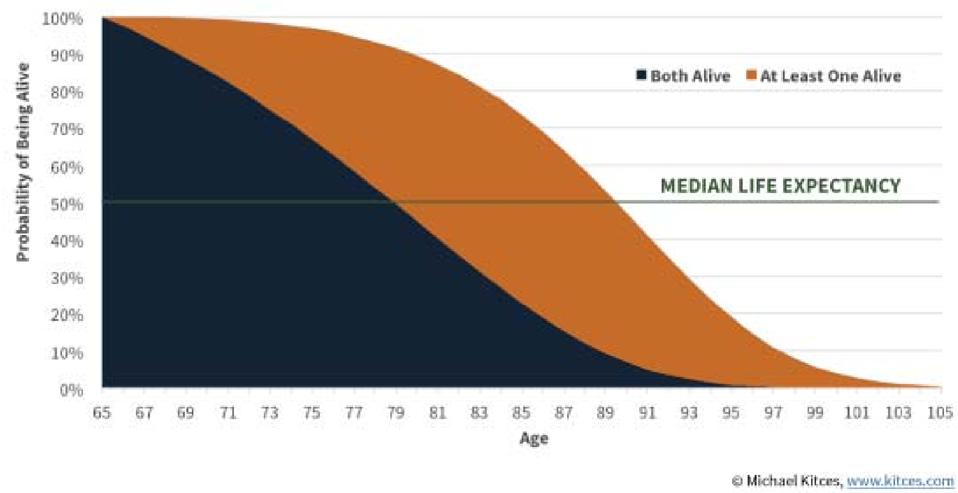
On the other hand, it is worth recognizing that once one member of the couple *does* decide to delay benefits, the decision to delay for one person actually makes it *less* valuable for the other member of the couple to delay as well!

> *Example 6.* Continuing the prior example further, assume that Angie *also* decides to delay her retirement benefit until age 70, so she too can be eligible for the 32% increase from delayed retirement credits. The bad news is that in order to benefit from the higher payments, she must live to the breakeven age (as is true for anyone who chooses to delay). But the worse news is that for Angie to benefit from the delay, *Brad must also live to the breakeven period*, as if Brad dies first, Angie will step *up* to Brad's $2,640/month *regardless of whether she delayed*.
>
> In other words, once Brad has already decided to delay, for Angie to *also* benefit from the delay, *both* members of the couple must live past the breakeven period (as Angie's early death fails to reach the breakeven, and Brad's early death overwrites Angie's benefit anyway). And if the couple is still eligible for Restricted Application, the outcome is

even worse, as Brad loses access to a $1,000/month benefit while they're both waiting as well.

What the above examples reveal is that it's often beneficial for the higher earning spouse to delay, because it works as long as *either* member of the couple are alive (either by receiving a higher retirement benefit for the person who delayed, or a higher survivor benefit for his/her spouse). *However*, once the higher earner delays, it's *less* beneficial for the other person to delay as well, because that only works as long as *both* members of the couple remain alive (otherwise the second person's delayed benefit is either lost due to death, or overwritten by the survivor benefit when the other person passes away).

Figure 13. Joint Life And Survivorship Life Expectancies For Couples



Notably, with typical growth rate and inflation assumptions, the breakeven period is normally in the individual/couple's early-to-mid-80s… a threshold where it's an odds-on bet that at least *one* of them will be alive (in fact, there's a more-than-50% chance that at least one will still be alive at age 90, thus making it highly beneficial for at least one to delay), but is actually an odds-*against* bet that both of them will be alive (as the odds that *both* remain alive past age 80 is a less-than-50% chance!), as shown in Figure 13.

The Four Key Options For Couples Claiming Social Security

In the past, coordinating the timing of Social Security benefits had a complex series of options, due to the potential for one member (or the other) of the couple to File-and-Suspend at full retirement age, or to file a Restricted Application, or to File-and-Suspend so the *other* spouse could file a Restricted Application… in addition to all the other choices of whether to start early or late.

Since the Bipartisan Budget Act of 2015, many of these choices are eliminated. The opportunity to File-and-Suspend is already dead (having ended on April 29 of 2016), with the new voluntary suspension rules rendering the popular strategy as moot. And while Restricted Application remains an option for those born in 1953 or earlier, its relevance will wind down in the coming years as those currently eligible either do so, or not, with future Social Security claimants no longer eligible, either.

Notwithstanding the wind-down of these rules, though, the fact remains that anytime there are two members of a married couple, the option for either, both, or neither, to delay benefits until later (or not) leads couples to consider four core Social Security claiming options:

- Both delay
- Husband delays
- Wife delays
- Neither delay

To the extent that all of these Social Security decisions will ultimately benefit (or not) by reaching the requisite breakeven age (which in turn is driven by growth rates, inflation rates, and the timing of benefits themselves), we can then analyze in which scenarios each of these claiming strategies may be advantageous.

When Both Should Delay

As discussed earlier, for a married couple to benefit by having *both* members of the couple delay, it is necessary for *both* of them to outlive the requisite breakeven period. If they both delay to receive higher benefits, but either one of them passes away before the breakeven period, the benefit of delaying is lost (for that person), either because his/her benefits end before the breakeven or because his/her benefits *overwrite* the other spouse's delay before *that* breakeven is reached.

Notably, this means that even if both members of the couple are "reasonably" healthy and of average life expectancy, it *still* may not be desirable for both to delay, as while the odds are good either will reach the breakeven period at average life expectancy, the *joint* probability that *both* survive will typically still be well under a 50% likelihood.

Moreover, the decision for both to delay can be especially undesirable in scenarios where there is a significant age gap between the couple, as the requirement for both to live to the breakeven period requires the *older* member of the couple to survive based on the *younger* person's breakeven period.

> *Example 7*. Dennis got married later in life to Suzanne, who is significantly younger than him. Now, Dennis is at his full retirement age of 66, but Suzanne is still only 51. Dennis has decided to delay his Social Security benefits to the maximum age 70, to increase both his benefit, and Suzanne's survivor benefit, and the couple is trying to decide whether Suzanne will delay her benefit as well.
>
> If Suzanne decides to delay all the way from age 62 (once she gets there) until age 70, she will still face the 'typical' breakeven period of needing to reach her early 80s. However, by the time *she* has delayed, claimed, and then reached her early 80s, Dennis will already be in his late 90s, and the probability that *both* Suzanne lives to her 80s *and* Dennis lives to his late 90s is very low. The couple would need to *both* be in very good health for the both-delay decision to be appealing. Otherwise, the fact that Dennis chose to delay may still be appealing, but Suzanne won't want to delay as well.

Ultimately, the decision for both members of a couple to delay should only be done in situations where there is a strong likelihood of longevity on *both* sides of the family, for a couple who are *both* in very good health at the time.

Social Security Spousal And Survivor Benefits For Same-Sex Married Couples

In order to be eligible for couples' Social Security spousal and survivor benefits, the couple must be legally married, in a marriage that is recognized by the Federal government in the first place.

Since the Supreme Court decision of *United States v. Windsor (2013)* the Federal government has been required to recognize a same-sex marriage that was legal where it was performed (though states could decide on their own whether to allow same-sex marriage or not), and after the subsequent *Obergefell v Hodges* (2015) decision, same-sex couples can be married in any state (and states can no longer ban or choose not to recognize such marriages).

As a result, any same-sex married couple is now eligible for spousal and survivor benefits, as long as the marriage was/is legal in the first place. For couples who were married before the Supreme Court decisions, the marriage remains legal and recognized as long as it occurred in a place that legally recognized the marriage at that time. For same-sex couples married since then, the marriage simply needs to be recognized under the same laws and process for which any legal marriage is recognized.

Thus, while Social Security benefits for couples are often discussed in the context of being a "husband's" benefit or a "wife's" benefit, ultimately spousal and survivor benefits can lead to a payment of benefits from Spouse A to Spouse B, regardless of gender, based on the same rules that otherwise apply to any couple. In addition, as same-sex couples are both married *and* subsequently divorced, an ex-spouse can be eligible for a divorcee's spousal and survivor benefit as well (again, as long as both the marriage, and subsequent divorce), were legal at the time and location where they occurred.

When (Only) One Person Should Delay Social Security

Given the challenge and risk of whether *both* members of a couple will live to the requisite breakeven period to make it appealing for *both* to delay, in most situations it's likely that one member will delay but the other will not. In other words, the husband will claim early while the wife delays, or the wife will claim early while the husband delays. (Or more generally, "A" can delay while "B" starts early, or "B" can delay while "A" starts early, given that "A" and "B" may be a husband-and-wife couple, or a same-sex married couple, as discussed in the sidebar.)

Given this dynamic, which member of the couple should delay, and which should start early? The answer: whoever has the higher benefit.

The reason that the higher earner of the couple should be the one who delays is rather straightforward: it is the benefit that will best maximize *both,* the earner's *own* retirement benefit, *and* the survivor benefit.

> *Example 8*. Ricky is age 62, and at his full retirement age, he will be eligible for a $2,000/month benefit. Lucy, his wife, is also age 62, and due to several years of staying home to raise a family and limited time in the workforce, has a Primary Insurance Amount of only $1,200/month.
>
> If Lucy were to delay her benefit to the maximum age 70, her benefit would rise to $1,584/month (plus cost-of-living adjustments), and she would need to reach a breakeven age around her early 80s for that delay to be worthwhile. Unfortunately, her decision to delay will *only* succeed if *she* lives that long, though, because Ricky will not be eligible for a survivor benefit from her if she dies early, since his own benefit is *already* larger.
>
> By contrast, if Ricky were to delay his benefit to age 70, it will raise to $2,640/month. As a result, the couple will benefit if Ricky survives to his breakeven age, *or if Ricky dies but Lucy survives long enough as she receives his $2,640/month survivor benefit.*

As the example shows, the virtue of having the *higher* earner delay is that it will typically produce *both* a higher retirement benefit for the person who delays *and* a higher survivor benefit for the other spouse, which makes it easier to reach the breakeven period because *either* just has to survive long enough to reach it.

Notably, though, because the higher earner's benefit will be available as a retirement benefit and/or a survivor benefit, *it actually doesn't matter which spouse is in better health when deciding which spouse should delay*. After all, as the example showed above, even if Ricky decides to delay and he's in poor health, Lucy will still enjoy all the benefits of his delay in the form of a much-higher survivor benefit, even if Ricky never lives long enough to enjoy more than one benefit check (e.g., if passes away shortly after his 70th birthday).

And, as shown earlier, once the couple does decide for the higher earner to delay to age 70, there is little value for the lower earner to delay *at all*, and instead would likely just begin benefits *as soon as* he/she is eligible at age 62. (Though it is still important to be cognizant of the Earnings Test; see sidebar.)

In situations where the couple has similar benefits, the tactic of the higher earner delaying while the lower earner remains just as relevant, if only because the decision *to* have one person start early while the other delays will turn two otherwise-equal benefits into very different benefits. (Though notably if both have the exact same benefit, it won't actually matter which one does the delay and which starts early.)

When Both Should Start Early

The scenario where both members of a married couple should start their benefits early is rather straightforward: it is appropriate when *both* are in poor health, such that *neither* is likely to survive the requisite breakeven period.

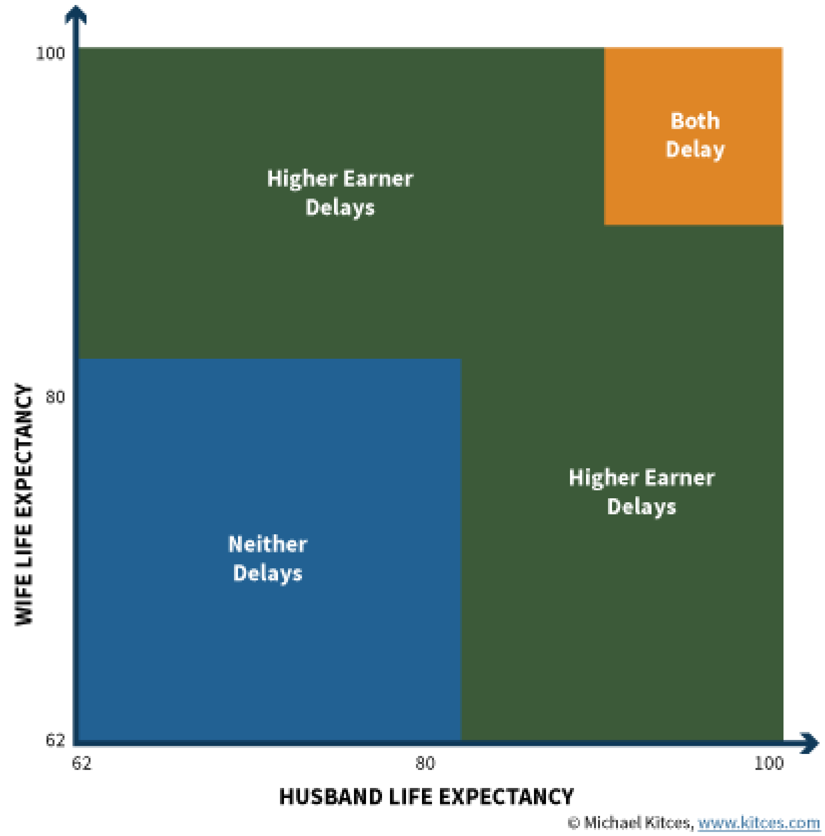
Notably, though, for it to be beneficial for both members of the couple to start early, it is important that *both* have poor health. If just one spouse has health issues, but the other is at least of average life expectancy, it will likely still be appealing for at least the higher earner to delay, *even if the higher earner is the one in poor health.*

Nonetheless, for those couples where neither are optimistic about life expectancy, the best course of action will generally be for each to claim their benefits as soon/early as possible.

Optimizing Couples' Benefits And Exceptions To The Rule

Given that the timing of claiming Social Security for a couple is driven primarily by their life expectancies and ability to reach the requisite breakeven periods (which themselves can be moving targets based on growth rate and inflation rate assumptions), we can identify the optimal Social Security claiming strategies by charting

Figure 14. Couples Claiming Strategies Based On Life Expectancy



them against the couple's respective life expectancies, as shown in Figure 14 (above).

As the graphic shows, in scenarios where *both* members of the couple have poor life expectancy – the intersection of less-than-age-80 life expectancies for *both* the husband *and* the wife – the optimal straight is for both to claim early.

In situations where at least one member of the couple has at least normal (or outright extended/favorable) life expectancy, the optimal strategy will generally be for the higher earner to delay (regardless of whether he/she is the one in good health or not), while the lower earner will start as early as possible.

And, in the subset of scenarios where *both* members of the couple are expected to live materially beyond life expectancy – such that there are favorable odds that *both* will simultaneously live past the breakeven period – the best strategy is for both to delay. But because the probability of *both* living past life expectancy is lower than *either* living *to* life expectancy, the area where it pays for both to delay is fairly narrow and typically requires *very* high life expectancy (such that their *joint life* expectancy for *both* to be alive is *still* past the breakeven period).

Notwithstanding these generally optimal claiming strategies, though, it is important to note that there are several important exception scenarios to consider.

Social Security Earnings Test

One of the most important caveats to the strategy of claiming early – whether it's an individual who doesn't otherwise want to wait, the lower earning spouse of a couple, or both members of a couple in poor health – is that it still doesn't pay to claim benefits before full retirement age for someone who is otherwise still working (and earning a material amount of income).

The reason is the so-called Social Security "Earnings Test", which can reduce early benefits that would otherwise be payable – potentially, all the way down to $0.

The Earnings Test applies to anyone who claims Social Security benefits early – before full retirement age – and has more than $15,720/year in employment income (either via wages or self-employment). To the extent that earned income exceeds this threshold, Social Security benefits are reduced by $1 for every $2 above the threshold. In the extreme, this can reduce Social Security benefits all the way to $0. In the first year of benefits, the Social Security Earnings Test is calculated on a monthly basis, in the months for which a Social Security benefit is actually received (which amounts to an Earnings Test of $15,720/year / 12 months = $1,310/month of earnings).

> *Example 9*. Darren has a Primary Insurance Amount of $1,800/month at age 66, but decides to start his benefits early at age 62, claiming a reduced benefit of just $1,350/month. However, Darren continues to work part-time, earning $2,000/month for the remaining seven months of the year after he turned 62 and started his benefits. As a result, Darren earns $690/month over the $1,310/month

Earnings Test threshold in his first year, reducing his benefit by $690 / 2 = $345/month.

Thus, Darren's net Social Security payments will only be $1,005/month instead of $1,350/month (and to the extent he receives the full $1,350/month initially, will have to repay the excess benefits later once the Social Security Administration affirms his subsequent monthly earnings and that he shouldn't have been paid that much in the first place).

In the year someone reaches full retirement age, the Earnings Test threshold is significantly higher – up to $41,880 – and again is only calculated on a monthly basis (at $3,490/month) for each month from the beginning of the year until the actual month in which full retirement age is achieved. For the year-of-full-retirement-age Earnings Test, the reduction itself is also diminished, and is only a $1 reduction for every $3 of earnings above the (higher) threshold amount.

Example 10. Continuing the prior example, if Darren continues his part time work throughout, in the year he reaches his full retirement age, he will no longer face an Earnings Test reduction. While he continues to earn $2,000/month, this amount is below the $3,490/month threshold amount that applies in the final year. Thus, upon reaching January 1st of the year in which Darren turns full retirement age of 66, he will no longer be impacted by the Social Security Earnings Test.

It is also important to recognize that while the Earnings Test does reduce Social Security benefits, any foregone benefits are *not permanently lost*. Instead, foregone benefits are ultimately "repaid" in the form of higher subsequent benefits after reaching full retirement age.

This adjustment at full retirement age is determined by calculating cumulatively how many months' worth of benefits were actually lost due to the Earnings Test, and unwinding the reduction that otherwise applied for having claimed benefits early.

Example 11. Continuing the prior example, assume that cumulatively Darren ended out *not* receiving 1/4th of his total Social Security benefits from age 62 to full retirement age of 66, due to the impact of the Earnings Test. Upon reaching full retirement age, the Social Security Administration will re-evaluate his benefits, recognizing that while he began payments four years early, since he lost 1/4th of his payments, he *really* only received the equivalent of three years' worth of early benefits.

As a result, Darren's benefit will be recalculated at full retirement age as though he had only claimed three years early to begin with, which means his benefit "should" have been $1,440/month instead of $1,350/month. Accordingly, going forward, the Social Security Administration will bump Darren's benefit up from $1,350/month to $1,440/month to make up for the prior reductions.

Example 12. Continuing the prior example even further, assume instead that Darren started Social Security benefits early, but ended out with a substantial consulting engagement immediately thereafter, that generated so much income that his Social Security benefits were reduced entirely to $0.

As a result, while he claimed benefits four years early, since he never actually received a single dollar of early benefits, at full retirement age of 66, Darren's benefit will be adjusted *back* to his original $1,800/month, as though he had never filed early – since in essence, he never actually did, given that he never received a single early payment!

As example 12 illustrates, the reality is that the Social Security Earnings Test actually functions more as a "forced delayed retirement" than an actual penalty to claiming early. At the extreme, the Earnings Test simply provides the retiree the same benefit they would have had by delaying to full retirement age in the first place.

Notably, the Earnings Test applies to any benefits that are received before full retirement age, including individual retirement, spousal, and survivor benefits. However, the Earnings Test applies *only* to *early* benefits; once reaching full retirement age, there is no limit on the amount of income that can be earned even while receiving full Social Security benefits as well.

In the context of coordinating Social Security claiming for a couple, though, the existence of the Earnings Test means there's no actual value to starting benefits as early as 62 for someone who is otherwise still working. Instead, starting "early" will generally mean starting at full retirement age (when earnings no longer impact early benefits), or starting Social Security benefits once any earned income ceases (or at least declines low enough to be below the threshold).

Single Income Households (Or Where The Lower Earning Spouse's Benefit Is *Much* Lower)

Another exception to the "general" rule for most couples to delay the higher earner's benefit late and claim the lower earner's early is the scenario where the lower earner's benefit is actually $0 (or near $0) due to limited time ever participating in the workforce (or at least, not enough to earn the requisite 40 quarters of coverage).

The reason that the split-claiming strategy doesn't work well in this scenario is that if the lower earner will rely primarily (or exclusively) on the spousal benefit, delaying the higher earner's benefit to age 70 could result in a period of time where the lower earner doesn't get any benefits *nor* gain anything by delaying, either.

> *Example 13*. As a couple, William was the primary breadwinner, while Catherine stayed home to raise the family. Now both at their full retirement age of 66, William will be eligible for a $2,200/month Social Security benefit, but Catherine is not eligible for a retirement benefit at all. The good news is that Catherine may ultimately be eligible for a $1,100/month spousal benefit, but she is not entitled to it until William actually files a claim. Yet if William decides to delay all the way until age 70 to earn delayed retirement credits, Catherine will be "stuck" waiting four years for her spousal benefit, *even though she receives no delayed retirement credits for waiting past full retirement age*.

Social Security Claiming Strategies For Divorcees

For divorcees who were married for at least 10 years, the opportunity to claim an ex-spouse spousal or survivor benefit creates additional planning strategies, even for those who are otherwise now "single" (and in fact, must be single and not remarried to claim an ex-spouse's spousal benefit).

In scenarios where the ex-spouse is otherwise still alive (and is at least age 62), the most popular claiming strategy was/is to file a Restricted Application for an ex-spouse's spousal benefit at full retirement age of 66, and then switch to the divorcee's own individual retirement benefit at age 70 (if greater). This allows the divorcee to gain all the benefits of delaying retirement payments until age 70, *and* claim a 50% (ex-)spousal benefit along the way. Unfortunately, though, with the changes in the Bipartisan Budget Act of 2015, going forward this strategy is only available to divorcees who were born in 1953 or earlier (regardless of which year the ex-spouse was born).

If an ex-spouse has passed away, a surviving divorcee has an opportunity to claim an ex-spouse survivor's benefit as well. Similar to survivor benefits in the not-divorced scenario, the optimal strategy for those who are otherwise optimistic about their health is to delay the higher benefit as long as possible, and claim the 'other' benefit as early as possible. For those in poor health, it is best to simply claim each benefit as it becomes available (as long as the Earnings Test won't otherwise apply). And because ex-spouse survivor benefits can apply even after remarriage – as long as the remarriage occurs at age 60 or later – some divorcee survivors might even consider delaying a remarriage scenario to/past age 60, just to ensure the divorcee survivor benefit is available.

Notably, one unique 'benefit' of ex-spouse benefits – particularly the ex-spouse's spousal benefit – is that becoming entitled is triggered not by the ex-spouse *filing* for benefits, but simply by virtue of being age 62. As a result, it's possible for *both* divorced spouses to claim an ex-spouse's benefit, and if both were born in 1953 or earlier, *each* can claim an ex-spouse's spousal benefit while delaying their own, which isn't possible for a married couple (due to the elimination of file-and-suspend rules). Consequently, for a married couple who were both born in 1953 or earlier and have reached full retirement age, it's actually possible to increase benefits for the couple by *choosing* to divorce, each filing a Restricted Application for the ex-spouse's spousal benefit, and then switching back to their full retirement benefit (and subsequently remarry) after age 60!

> The end result is that William's decision to delay generates an 8% delayed retirement credit on his $2,200/month benefit, but costs the couple $3,300/month in foregone benefits to earn it!

In scenarios like the example above, the fact that *both* of their benefits will be delayed, even though only one person's benefit gains a delayed retirement credit, significantly increases the breakeven period, and reduces the value of delaying the higher earner's benefit.

Notably, this dilemma can apply not only when the lower earning spouse's benefit is $0, but where it's "merely" significantly lower, as well.

> *Example 14*. Continuing the prior example, assume instead that Catherine did work enough years outside the home to earn a modest $800/month retirement benefit of her own. If William delays to age 70, Catherine can still start *her* benefits earlier, at her full retirement age, and claim her $800/month. Still, the fact that she can *only* claim her $800/month retirement benefit, and isn't entitled to her $1,100/month spousal benefit (losing out on the extra $300/month of spousal benefits because William hasn't claimed yet), implicitly increases the breakeven period for William to benefit from his delay.
>
> In other words, for every year that William delays, he will earn an 8%/year delayed retirement credit on his $2,200/month, but the couple will lose $2,200/month + $300/month = $2,500/month.

In this scenario where the spouse has her own retirement benefit, but it is even less than the spousal benefit, the cost of delaying the higher earner past full retirement age is somewhat diminished, but still has an impact that should be considered.

Notably, though, this scenario is not an issue when the lower earning spouse is more than four years younger than the higher earner, as by the time the higher earner delays until age 70, the lower earner will not yet even be full retirement age anyway.

> *Example 15*. Continuing the prior example further, assume that Catherine is five years younger than William. When William reaches his full retirement age of 66, then Catherine will still only be 61, and not eligible for a spousal benefit anyway, so there is little harm in delaying. In fact, by the time William delays to age 70, Catherine will still only be age 65, and the delay will not adversely harm her, as waiting from age 61 to 65 *does* increase Catherine's spousal benefit for waiting (by avoiding the early benefit penalty that would otherwise apply).
>
> Thus, given the age gap of the couple, the decision for William to delay is not adverse after all.

Delaying Social Security and Potential "Reform"

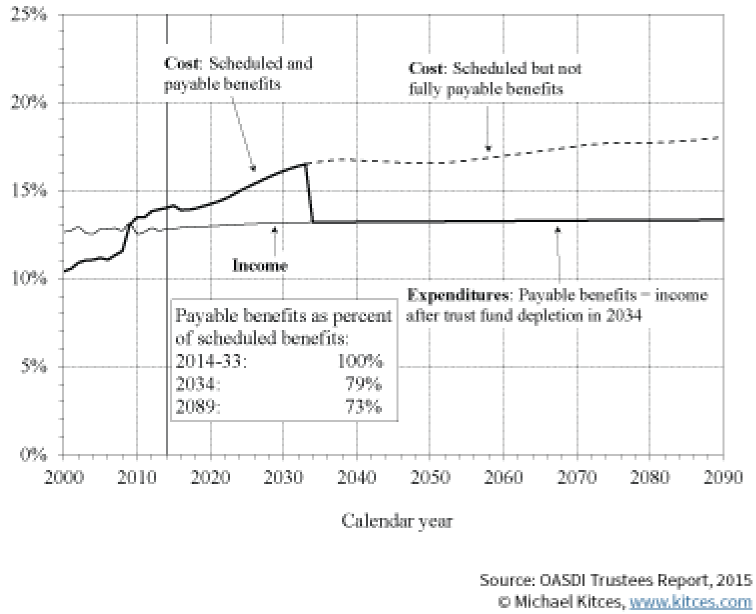
While for many Americans, strategies to delay Social Security are a moot point because they simply don't have the available resources *to* delay (i.e., are no longer employed, and cannot support themselves with other assets), for those who *do* have the financial wherewithal to delay, often there is a decision not to do so anyway. The commonly cited reason is that it is best to "claim Social Security while you can" out of a fear that benefits will soon go away, given the current financial health of the Social Security program.

In point of fact, the latest 2015 Trustees Report for Social Security does show that current tax revenues, plus liquidation of the bonds held in the Social Security trust fund, will only be capable of maintaining Social Security payments until approximately the year 2034, after which the government bonds held in the trust fund will be depleted and there will not be enough cash flow coming in to pay benefits in full.

However, even beyond this point, the reality is that Social Security benefits are not fully eliminated. Because the overwhelming majority of Social Security benefits are funded directly by payroll tax revenues (i.e., the FICA taxes on current workers are translated directly to benefits payments for retirees), *even after the Social Security trust fund is depleted, Social Security will be able to continue paying approximately 79% of its benefits at the time, and maintain at least 71% of benefit through 2089* (the end of the latest 75-year projection window).

In other words, the "worst" case scenario is not actually that Social Security goes "broke". It's simply that payments beginning in 2034 will experience an immediate 21% "haircut" (because the Social Security trust fund isn't available to cover the 21% shortfall once it's depleted), which gradually shifts to a 29% haircut over the subsequent decades, as shown in Figure 15.

Figure 15. Projected Social Security Benefits Shortfall Over 75 Years



In turn, this also means that the required solutions to resolve the projected shortfalls in Social Security are also not as dire as many suggest. Widespread "means testing" or "confiscation of benefits" is actually not necessary. As noted above, the worst-case scenario is a payment haircut of 21%, and that's if *nothing* is done to shore up the system for the next 18 years or so. If benefits were to be cut now to ensure full benefit solvency for the next 75 years, the required cut would only be 16.4%.

Alternatively, the projected Social Security shortfall (in both retirement benefits, and the disability insurance fund, which has its own woes) could also be resolved by a "mere" 2.62% increase in FICA payroll taxes (from the 12.4% share for Social Security rising to 15.02% instead). While a roughly 2.6% increase in tax rates across the entire economy is not "trivial" in its economic consequences, it's ultimately a fairly modest tax rate increase in a world where FICA taxes are already 12.4%, and the maximum ordinary income tax bracket goes as high as 39.6%!

Other proposals that would bridge the Social Security shortfall – which also help to mitigate any "drastic" impact – are shown in Figure 16, and could be done either individually, or in some combination.

Ultimately, the fundamental point is simply that despite the popular media discussion, Social Security is not actually as "broke" as it is often made out to be, with a "worst case" scenario (if we do nothing to resolve the shortfall before it hits) being just a 21% benefits cut in 2034, which can be resolved by some (moderate) combination of a 1%-2% increase in payroll taxes, slight boost of the full retirement age threshold from 67 (where it's phased in to now) up to 68 or 69, or making modest adjustments to the Social Security wage cap or bend points.

As a result of these dynamics, taking Social Security benefits early, to avoid the "risk" of benefits being lost later, will generally not be a winning proposition for most retirees (at least in today's environment). In fact, a retiree who delays to age 70, *and* faces a 21% cut in benefits in the year 2034, will *still* enjoy a drastically

Figure 16. Potential "Fixes" To Resolve Projected Social Security Deficits

Proposal	Percentage Of Shortfall Eliminated
Reduce annual cost-of-living adjustment (COLA) by 1%/year	65%
Reduce upper social security bend points from 32% and 15% to 21% and 10%, respectively, over the next 30 years	56%
Adjust social security benefits to calculate a 40-year average instead of 35 year average	17%
After full retirement age reaches 67 in 2022, raise it to 68 by 2028	16%
Increase full retirement age to 69 by 2034	38%
Eliminate social security wage cap (but allow 15% bend point to apply all income)	71%
Increase payroll taxes by 2.6% (from 12.4% to 15%)	~100%

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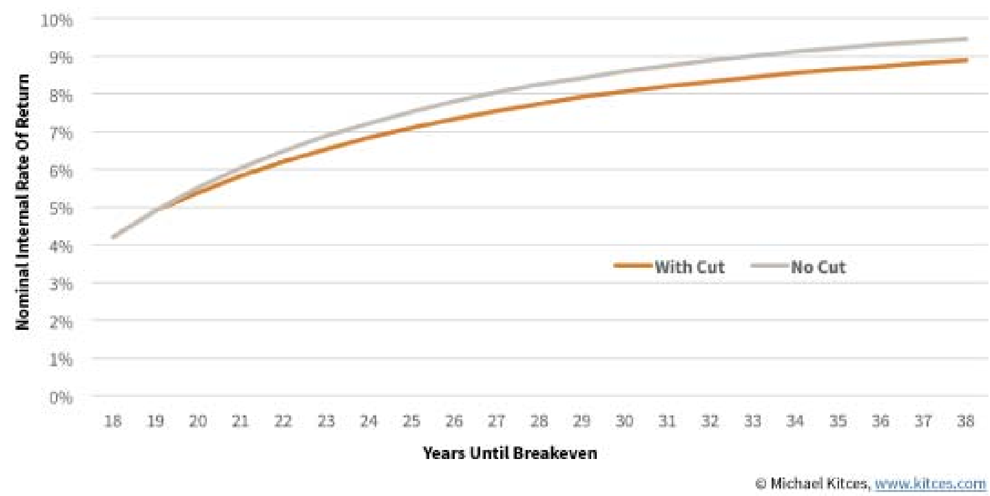
Figure 17. Projected IRR For Delaying Social Security With And Without Benefits Haircut In 2034



better long-term internal rate of return on the Social Security delay decision than available government bond alternatives today, as shown in Figure 17 above (in nominal yield, assuming 3% inflation)!

Conclusion

In the end, the timing of when to claim Social Security benefits is an important planning strategy – one that has fewer choices since the Bipartisan Budget Act of 2015 eliminated File-and-Suspend and has begun to wind down Restricted Application, but choices remain nonetheless. An individual must still decide whether delaying is appealing as a hedge against longevity, bad market returns, and/or high inflation, and couples have additional opportunities to coordinate claiming strategies to maximize survivor and spousal benefits as well.

Of course, for the clients of most financial planners, the reality is that the decision of whether to delay Social Security (or not) shouldn't be made in isolation, but in the context of the entire financial picture, including other available assets. Yet when evaluated in conjunction with the portfolio, the decision to delay Social Security – even if it entails spending more from the portfolio in the meantime – should be especially appealing, as delaying Social Security can generate real returns in the long run far in excess of comparable-risk investment alternatives (the equivalent of a government bond with a real return as high as 6% for those who delay and survive until age 100!). In addition, the scenarios that most benefit delayed Social Security, including significant longevity, high inflation, and low market returns, are the greatest threat to a portfolio-based retirement, which means delaying Social Security is an effective hedging strategy as well.

Nonetheless, even in scenarios where a delay is determined to be favorable, couples in particular must still further evaluate the situation, to determine whether they will *both* delay, or whether it is better to just delay the higher earner's benefit, and then claim the other early, to maximize the likelihood of a favorable outcome.