

# INNOVATIVE STRATEGIES TO HELP MAXIMIZE SOCIAL SECURITY BENEFITS

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“For years, financial services companies have downplayed the role of Social Security in bolstering financial security in retirement. However, considering the increased financial risks retirees now shoulder, the tax preferences that Social Security receives, and the income options that Social Security now offers, a strong argument can be made that Social Security should play a greater role in a retiree’s financial planning.”

What’s the greatest fear of today’s retirees? It is having enough money to maintain one’s lifestyle throughout retirement.<sup>1</sup> What’s the greatest benefit Social Security can offer? Regular income that is guaranteed to increase over time—and continue for as long as you live.\* No other vehicle can match the combination of inflation-fighting increases, longevity protection, investment risk elimination, and spousal coverage that Social Security can—potentially making it one of the most valuable sources of retirement income. On average, Social Security accounts for about 40% of income in retirement.<sup>2</sup>

However, many retirees today do not understand how their Social Security benefits really work. Sadder still, most never focus on how to help maximize the very benefits that may help sustain them throughout retirement.

Financial services firms have placed little emphasis to date on helping retirees learn how they can best use Social Security to help generate optimal retirement income and risk protection. If guidance is provided at all, it may not provide complete information, as this paper will show.

Maximizing Social Security benefits has become much more critical—now that post-retirement risk has largely shifted from the employer to the individual. This results from the move away from traditional defined benefit (DB) pensions to defined contribution (DC) plans such as 401(k)s.

This paper will outline why Social Security deserves to be considered as a valuable resource worthy of careful stewardship by individuals—and how today’s retirees can best maximize its benefits while helping minimize the taxes on their retirement income in general.

\*Social Security taxes are just that—taxes, and convey no property or contractual rights to Social Security benefits. As a result, a worker’s retirement security is entirely dependent on the political decisions of the President and Congress. Benefits may be reduced or even eliminated at any time.

<sup>1</sup>Prudential Financial, “Financial Experience & Behaviors Among Women,” July 2012.

<sup>2</sup>Employee Benefit Research Institute, “EBRI Notes,” June 2010, Volume 31, Number 6.

# Chapter 1: Four costly mistakes retirees make about Social Security

While some retirees are simply uninformed, others are dangerously misinformed by the “conventional wisdom” surrounding Social Security. Unfortunately, these misconceptions prevent individuals from taking the steps that are well within their control to help maximize this important benefit. Here are four costly mistakes retirees often make about their Social Security benefits.

## Four costly mistakes retirees make about Social Security

**Mistake #1:** Underestimating the real value of Social Security

**Mistake #2:** Rushing to collect, then regretting the reduced benefits for the rest of your life

**Mistake #3:** Not understanding the various ways married couples can integrate their benefits

**Mistake #4:** Getting blindsided by the “Tax Torpedo”

## MISTAKE #1: Underestimating the real value of Social Security

For years, financial service providers have warned us that Social Security will never provide enough income during retirement. While this may be true for many, it is an important component of total retirement income nonetheless. In particular, at the point of retirement, Social Security should be anything but ignored.

As the income guarantees provided by private employer pension plans disappear, Social Security guarantees become even more critical to individuals, who may spend 25, 30, or

even 40 years in retirement. In reality, no retiree knows how long he or she will live and most run the risk of outliving their income. Social Security provides valuable protection against this “longevity risk.”

In fact, while you are working, the value of Social Security continues to grow along with wages. Once you start receiving Social Security during retirement, these benefits are adjusted for inflation each year and help preserve the purchasing power of your retirement income.

Rather than ignoring this retirement resource, we should embrace it. For many retirees, Social Security will become the centerpiece of retirement income. They need to understand how best to take their Social Security benefits and how their decisions will affect them throughout retirement—which will often last one-third of their lives.

**Example: A 66-year-old worker with \$80,000 of final wages and a non-working spouse can expect approximately \$34,000 of initial annual Social Security income.**

Some never take charge of this benefit because they discount the viability of the system in general. Whatever your personal beliefs are about the Social Security reform debate or a “pay-as-you-go system,” most new retirees have been paying into the Social Security system for many more years than they have contributed to their defined contribution plans. They need to consider both as critical sources of their retirement income.

Other than calling for an adjustment to the Cost-Of-Living-Adjustment (COLA) formula, no serious reform proposal has been offered that would reduce Social Security benefits for those at or near retirement. Although Social Security is not guaranteed by law, it is backed by the promise of the U.S. government.

## Key Terms

Cost-Of-Living-Adjustment (COLA)	The amount a Social Security benefit increases annually, based on increases in the cost of living
Delayed Retirement Credit (DRC)	The annual amount by which the initial benefit is increased each year, if claiming is delayed past Full Retirement Age
Full Retirement Age (FRA)	The age at which a person may first become entitled to full or unreduced retirement benefits
Primary Insurance Amount (PIA)	The Social Security benefit an individual receives at his/her Full Retirement Age

### MISTAKE #2: Rushing to collect, then regretting the reduced benefits for the rest of your life

Compared to earlier generations of retirees, Social Security will replace less of pre-retirement earnings, as the Full Retirement Age has risen from 65 to 66, and is heading to 67 for those born after 1954.<sup>3</sup> Nevertheless, retirees often apply for Social Security benefits early. Most certainly didn't stop to think that, once reduction penalties as well as foregone Delayed Retirement Credits and COLAs are factored in, they could have potentially doubled their initial payments if only they had waited until age 70.

The discussion regarding when to take Social Security benefits tends to focus on the "break-even" age, that age at which you could receive more income from starting Social Security benefits earlier versus starting them later. Some calculators will also factor in the time value of money, since retirees receiving "early" Social Security benefits could theoretically invest this income for use later in retirement. However, these assumptions often ignore key considerations:

- The value of Social Security COLAs, which, although not guaranteed by law, are a promise made by the government that would be difficult to cancel;

- The tax preferences awarded to Social Security income compared to IRA withdrawals;
- The potential interaction between spousal benefits, and the ability to integrate each spouse's benefits to provide optimal income and protection;
- The survivor's benefit, which is passed on to a spouse at death;
- The ability of Social Security to provide longevity risk protection in the form of retirement income for life; this is particularly important since no one can accurately predict how long they will live in retirement.

### MISTAKE #3: Not understanding the various ways married couples can integrate their benefits

Perhaps the most confusing aspect of Social Security claiming is trying to understand the different types of retirement benefits for which married spouses might be eligible, and how those benefits might interact with each other. At one time or another, a married spouse might be receiving a spousal benefit, a worker benefit, or a survivor benefit. Whether both spouses worked and earned benefits or whether only one spouse did, there are ways to optimize benefits by developing a claiming strategy. To create the right strategy for a given situation, it is important to first understand the different types of benefits and when they might become available.

#### Full Retirement Age

Year of Birth	Full Retirement Age
1943-1954	66
1955	66 and 2 months
1956	66 and 4 months
1957	66 and 6 months
1958	66 and 8 months
1959	66 and 10 months
1960 and later	67

Note: The chart reflects the Full Retirement Age for retired worker and spousal benefits. For survivor benefits, the Full Retirement Age is different for some years of birth.

<sup>3</sup>Center for Retirement Research, "Will We Have to Work Forever?," Issue Brief Series 4, July 2006, page 1.

## THE EARNINGS TEST

**If you start worker, spousal, or survivor benefits prior to your Full Retirement Age, you will likely be subject to the earnings test. With the earnings test, if you start your benefits early, in every year leading up to the year you reach your Full Retirement Age, \$1 in benefits will be withheld for every \$2 you earn above the limit for that year (\$14,640 in 2012). During the year you reach your Full Retirement Age (age 66 for those born prior to 1955), your benefits are reduced \$1 for every \$3 you earn above a higher limit (\$38,880 in 2012), until the month you reach your Full Retirement Age. At that point, the earnings test disappears. Throughout this paper, when benefits and strategies are described, the assumption is made that the earnings test does not apply.**

## Types of Retirement Benefits

**THE WORKER BENEFIT** – If you have worked and contributed to the Social Security system for 40 quarters, you are likely eligible for a worker benefit. This benefit, at your Full Retirement Age, is known as the Primary Insurance Amount (PIA). The earliest you can file for your worker benefit is the first month in which you are age 62 for the full month. As a result, most individuals are first eligible for their worker benefit at age 62 and one month. Actuarial reductions apply if you take your benefit prior to your Full Retirement Age. The Full Retirement Age is 66 for those born between 1943 and 1954. If you wait beyond your Full Retirement Age to claim your benefits, a Delayed Retirement Credit of 8% per year will apply. While you are waiting to claim your benefits at any age from 62 to 70, COLAs will also apply and compound over time. For example, if you wait from age 68 to age 69 and the government has declared a 3% COLA, your benefit will grow 11% (8% Delayed Retirement Credit plus 3% COLA) for that year.

**THE SPOUSAL BENEFIT** – Assuming that the other spouse has filed for benefits, spousal benefits can begin the first full month that an individual is age 62. Spousal benefits, however, do not earn Delayed Retirement Credits if a benefit is delayed past Full Retirement Age.

This benefit is often thought of as being the greater of what a spouse earns on his/her own work record, or one-half of the other spouse's benefit. Unfortunately, it gets more complicated than that. To understand how the spousal benefit works, let's assume that we have a married couple in which Ken was the higher earner, Mary was the lower earner, and both turn age 62 (and become eligible for benefits) on the same day. Let us also assume that Ken and Mary's Full Retirement Age is 66.

If Ken has filed for his worker benefit, a spousal benefit *may be* payable to Mary. The simplest way to consider whether Mary is eligible for a spousal benefit when she is younger than 66 is to determine what her worker benefit is at age 66. This amount is her PIA. Ken also has a PIA calculated at age 66. If Mary's PIA at 66 is less than one-half of Ken's PIA at 66, then Mary is eligible for a spousal benefit. The spousal benefit amount will be the difference between Mary's PIA and one-half of Ken's PIA. Therefore, although many might think that Mary is receiving a large spousal benefit based on Ken's work record, she actually is receiving two benefits—her own worker benefit plus the spousal benefit. It bears repeating that Ken must have filed for his worker benefit for Mary to become “entitled” to a spousal benefit, and that this example depicts the spousal benefit situation for Mary *prior* to her Full Retirement Age. Both a worker benefit and a spousal benefit (if the other spouse has filed) can be taken earlier than age 66 and are subject to actuarial reductions. Worker and spousal benefit reduction amounts are at different rates (with reductions slightly higher for spousal benefits).

To see how the numbers work, let's assume that Ken is eligible for a worker benefit of \$2,000 per month at age 66 (his PIA). Let's further assume that Mary is eligible for her own worker benefit of \$600 per month at age 66 (her PIA). One-half of Ken's PIA (\$1,000) minus Mary's PIA (\$600) leaves Mary eligible for an additional \$400 in the form of a spousal benefit. If Ken and Mary filed at age 66, Ken would receive \$2,000 and Mary would receive \$1,000. Mary's \$1,000 might be thought of as a spousal benefit, but it really is made up of two parts, her own worker benefit (\$600) and her spousal benefit (\$400).

Following are some important things to consider, as there is often confusion surrounding the payment of spousal benefits. First, Ken could start his worker benefit early, and his \$2,000

would be reduced. For example, he might claim his benefit at age 62 at the reduced amount of \$1,500 per month (75% of his PIA). Even if Ken started his benefits early, Mary could wait until her Full Retirement Age to start all her benefits and still receive the full \$1,000. In other words, the \$400 spousal benefit is not reduced, even though the worker on which they are based (Ken), started his benefits early.

Second, if Ken has filed for benefits, and Mary is younger than age 66, she cannot file for only one type of benefit. If she files for her worker benefit or her spousal benefit, she is “deemed” to be filing for both. (As will be discussed, her options change once she reaches her Full Retirement Age of 66.)

Third, if Ken does not file for his worker benefit early, Mary cannot file for her spousal benefit. If Ken waits until age 66 to receive his full, unreduced amount of \$2,000, and Mary wants to file at an earlier point, she can only apply for her worker benefit of \$600, subject to actuarial reductions. For example, Mary could apply for her worker benefit at age 62 and receive \$450 (75% of her PIA). At age 66, once Ken has filed for his worker benefit, she would receive an additional \$400. At that point she would be receiving \$850 (plus any COLAs), not \$1,000. Many are under the impression that Mary’s benefit would increase to one-half of Ken’s benefit once he applied, but this is not the case. By starting her worker benefit early, she locks in a permanent reduction on this benefit. The spousal benefit is added on later in this example. Of course, if Mary took the spousal benefit at any age prior to age 66, then it would be subject to a separate actuarial reduction. For example, if Ken filed for his worker benefit at age 65 and Mary decided to start her spousal benefit at age 65 as well, the \$400 potential spousal benefit would be permanently reduced to \$366 because Mary started 12 months early.

**THE SURVIVOR BENEFIT** – Delaying Social Security not only increases an individual’s own benefit, but can also increase the benefit to a surviving spouse. Upon the death of an individual, the spouse will receive the greater of:

- 1) His/her own then-current benefit, including any COLAs; or
- 2) The deceased spouse’s then-current benefit, including any COLAs. (In this case, #1 drops off whether it was a worker benefit, a spousal benefit, or some combination of the two.)

In essence, the value of delaying Social Security continues, as the higher benefit (which has grown even higher due to COLAs) is passed on at death to a spouse (See Figure 1). This is an important way to help provide income protection to a surviving spouse. It is also worthwhile to note that the smaller benefit drops off at this time. As a result, no matter which spouse dies first, the smaller benefit will drop off. This lessens the value of delaying Social Security for the spouse with the smaller Social Security benefit, and should be a consideration as to when this spouse should claim benefits.

The transition from DB plans to DC plans will make more spouses vulnerable to the risk of running out of money later in life; the qualified joint and survivor annuity, which is mandated in DB plans, is often not part of a DC plan offering. The larger Social Security income survivor benefit could help offset potential healthcare costs, nursing home costs, and everyday expenses. It also helps protect surviving spouses from inflation (since they’ll receive annual COLAs). Plus, it costs nothing more for this additional benefit. Better still, the larger Social Security survivor benefit is taxed at a lower rate than other ordinary income. It’s difficult to reproduce this security for a spouse through other financial vehicles.

**Figure 1**

**Example: How delaying Social Security can benefit a surviving spouse**

	If both spouses start collecting benefits at age 62, and the husband dies at age 82	If the wife collects at age 62, the husband delays benefits to age 70, and he dies at age 82
Initial benefit for husband	\$12,000	\$26,751
Initial benefit for wife (on her own work record)	\$12,000	\$12,000
Benefit that will continue for surviving spouse	\$21,673	\$38,133

*Note: The above example is hypothetical and for illustrative purposes only. It assumes both spouses are the same age and that the death of the husband occurs in 20 years, at age 82. COLAs are projected at an assumed rate of 3% per year.*



However, many retirees appear to focus only on the initial Social Security benefit amount and not the “second stage” benefit calculation, the survivor benefit. When this second stage calculation is taken into account, married couples may often find that, if retirement income is needed, it’s beneficial for the spouse who is eligible for the lower Social Security payments to start collecting his/her own worker benefit early—while delaying the other spouse’s benefits.

Then, at the death of the primary breadwinner, the lower-benefit spouse will “step up” to a much higher benefit. In essence, when the primary worker delays benefits, at the death of the first spouse, the smaller benefit drops off and the larger benefit continues. When considering whether to delay Social Security, not only should the worker’s expected longevity be considered, but, perhaps more importantly, the spouse’s as well.

### Claiming Strategies for Married Couples

There are a number of little-known claiming strategies available to allow married couples to take advantage of survivor benefits as well as the rules surrounding the claiming of spousal benefits.

**FILE AND SUSPEND** – Prior to 2000, if a worker delayed collecting Social Security, the spouse would not be able to collect spousal benefits, nor would the spouse be receiving Delayed Retirement Credits, since spousal benefits do not increase after an individual reaches Full Retirement Age. This reduced the value of delaying Social Security for many couples.

Fortunately, changes made under the Senior Citizens’ Freedom to Work Act of 2000 allow a worker to “file and suspend” Social Security benefits once the Full Retirement Age has been reached. This allows the spouse to begin receiving spousal benefits based on the worker’s record, while the worker continues to accrue Delayed Retirement Credits.

Using our sample couple, Ken could file for and then immediately suspend his benefits at age 66. His worker benefit would be delayed from age 66 to age 70 and grow from \$2,000 to \$2,640 (plus COLAs). When he files and suspends his benefits at age 66, Mary begins to receive an additional spousal benefit.

**FILE A RESTRICTED APPLICATION** – Once you have reached your Full Retirement Age, you will no longer necessarily be deemed to be filing for all your available benefits. As a result, another strategy becomes available.

Assuming that your spouse has filed for worker benefits, you could file for ONLY a spousal benefit based on your spouse’s work record, while letting the benefit based on your own work record grow until age 70 by earning Delayed Retirement Credits. This process is referred to as filing a restricted application for a spousal benefit. Interestingly, the spousal benefit at this point is not reduced by your own worker benefit, but rather is based on half of your spouse’s Full Retirement Age benefit (his/her PIA).

**Example: Let’s assume Mary’s worker benefit is higher than the earlier example, at \$1,200 per month at age 66. If Ken files for his worker benefit of \$2,000 per month at age 66 and Mary decides to file a restricted application for a spousal benefit, she would receive \$1,000 monthly at age 66, while her worker benefit of \$1,200 would grow to \$1,584 (plus COLAs) at age 70.**

Mary would switch from the spousal benefit to her worker benefit at age 70. She has used the spousal benefit to bridge to a higher worker benefit, which she will receive until either she or Ken dies. Should Ken die first, she would step up his current benefit (\$2,000 plus accumulated COLAs).

**COMBINING THE TWO** – There is a way to combine the two strategies, with one spouse filing and suspending a worker benefit while the other spouse files a restricted application for only a spousal benefit. Using the example just discussed, instead of filing for his worker benefit at age 66, Ken could file and suspend his worker benefit at age 66 and then delay that benefit to age 70. Meanwhile Mary could file a restricted application for her \$1,000 spousal benefit and let her \$1,200 worker benefit earn delayed retirement credits until age 70.

You cannot file and suspend your benefit and then file a restricted application for a spousal benefit, because you are “deemed” to have filed for your own worker benefit when you file and suspend your benefit. As a result, one spouse could file and suspend while the other could file a restricted application. However, it is not permissible for each spouse to file and suspend his or her own worker benefits and then file a restricted application for a spousal benefit based on the other’s work record.



### MISTAKE #3 – KEY POINTS TO REMEMBER

- To receive a spousal benefit based on your spouse's work record, your spouse must have filed for benefits.
- Prior to your Full Retirement Age, you are deemed to be filing for all available benefits, and cannot choose one type of benefit (e.g., worker benefit) over the other (e.g., spousal benefit).
- If you start your worker benefits early, they don't increase later in the form of a spousal benefit. A spousal benefit may indeed become available later, but the total benefit will always be lower, since at least a portion (the worker benefit) started earlier than your Full Retirement Age.
- No matter which spouse dies first, the smaller benefit is eliminated and the larger benefit continues.
- Two little-known strategies are available for married couples, the "file and suspend" method and the "filing a restricted application" method. If both spouses have reached their Full Retirement Age, these two strategies can be combined, with one spouse filing and suspending, and one spouse filing a restricted application for a spousal benefit.
- If you choose to file and suspend your benefit, be sure to pay your Medicare Part B premiums out of pocket. If you do not, Social Security will pay the benefit for you and treat you as if you are waiving, not suspending, your benefit.

### MISTAKE #4: Getting blindsided by the "Tax Torpedo"

Think of all the contributions that have been made to 401(k)s and other types of DC plans over the years. Now add all the employers' matches on those contributions ... and all the earnings on those matches and those contributions. All that tax-deferred money is just sitting there, much of it likely to be rolled over to an IRA. However, all of it will eventually have to be withdrawn—and taxed.

Not only will these withdrawals be subject to tax, but they will also generate higher incomes—and therefore trigger higher taxation of Social Security benefits. Instead of enjoying a lower marginal tax rate in retirement, as most believe they will, the marginal tax rate on 401(k) and IRA withdrawals may be much higher for many retirees than the marginal tax rate they were paying on their earnings when they were working.

Put it all together, and you'll see that we're facing what one journalist has called the "Tax Torpedo."<sup>4</sup>

Individuals for the most part understand that they face ordinary income taxation of their 401(k)/IRA withdrawals in retirement. Yet the tax situation is often worse for the retiree than expected. Once a very low income threshold is met (\$34,000 for singles and \$44,000 for married couples), every dollar received from an IRA causes up to 50% of a Social Security dollar to become taxed as well. At a second threshold, up to 85% of a Social Security dollar will become taxable. Assuming a 25% federal tax bracket, this creates a marginal tax of 46.25% on IRA dollars. Applicable state taxes may push the marginal tax rate to over 50%. This situation may get worse if ordinary tax rates increase in the future. The conventional wisdom to always delay, if possible, withdrawals from tax-deferred accounts may not be optimal for many retirees, since they are only creating a greater deferred tax liability due to the high marginal tax rates they may be paying on IRA withdrawals.

Ironically, even though the Tax Torpedo hits seniors very hard, no one has really looked closely at how to avoid it. Fortunately, it can be avoided—as we'll discuss in the next two sections of this paper.

Of course, it's also possible tax rates will increase. Given that cuts to Social Security, Medicare, and Medicaid are politically challenging to make, policymakers may resort to raising taxes in light of the projected federal budget deficit.

<sup>4</sup>"Torpedo Tax Can Cause a Sinking Feeling," *The Dallas Morning News*, February 11, 2003.

# Chapter 2: What you haven't heard before about the taxation of Social Security benefits

Put aside what you think you know about how Social Security is taxed. Based on how the taxation of Social Security benefits is discussed in the marketplace and the media, it is clear that this information is not widely understood. Although the following discussion may become confusing at times, it is being presented so that retirees and their advisors can learn about a way to lower taxes under current law. Lower taxes should translate into higher amounts of after-tax retirement income and an improved standard of living.

Here's the key thing to remember: Social Security income is not taxed the same as IRA income. As a result, you can reduce your taxes by choosing higher Social Security income and lower IRA withdrawals when you develop your strategy for taking retirement income.

## COMPARING HOW IRA WITHDRAWALS AND SOCIAL SECURITY INCOME ARE TAXED

Remember that a retiree can choose how and when to take IRA withdrawals and Social Security income. If you choose to take IRA withdrawals first, while delaying the start of Social Security benefits, you're choosing to take higher lifetime Social Security and lower IRA withdrawals. As will be explained below, many individuals who take IRA withdrawals will trigger the taxation of their Social Security benefits that they have already received that year.

Social Security income may be received tax-free. However, once certain income thresholds are met, \$25,000 for singles and \$32,000 married couples, up to 50 cents of every Social Security dollar becomes taxed. These thresholds are part of the Combined Income formula, also referred to as the Provisional Income formula (See Figure 2). In essence, IRA withdrawals received often push Social Security income over the threshold. When the total income calculated under

the Combined Income formula pushes Social Security above a second threshold (\$34,000 for singles and \$44,000 for couples), up to 85 cents of every Social Security dollar can become taxed.

This method of calculating the taxation of Social Security benefits can create very high marginal tax rates on IRA withdrawals when it is received in retirement. In fact, every additional dollar in IRA withdrawals often causes 85 cents of a Social Security dollar also to become taxable. A 46.25% marginal tax rate applies to that one additional dollar of income if the retiree is in the 25% tax bracket:  $(\$1 \text{ (of IRA income)} + [\$1 \text{ (of Social Security income)} \times .85]) \times .25$  (tax rate).

Nearly all experts make the "false leap" that the tax on Social Security can't be avoided, and therefore assume that 85% of all Social Security will be taxed as ordinary income once singles and couples hit the retirement income thresholds of \$34,000 and \$44,000 respectively. However, this is not true!

Upon closer analysis of the Combined Income formula (aka Provisional Income formula), you can see that Social Security income only goes into the formula at a 50% rate. All IRA income and even tax-free municipal-bond income counts at 100%.

## Figure 2 What is the Combined Income formula, and how does it work?

The Combined Income formula (also known as the Provisional Income formula) determines how much of a retiree's Social Security benefits are subject to taxation. Up to the thresholds listed below, Social Security benefits are tax-free. Once the first threshold is reached, up to 50% of Social Security benefits are subject to taxation. Once the second threshold is reached, up to 85% of Social Security benefits will be taxed. Listed below are the current first and second threshold limits, respectively.

**Single person: \$25,000 and \$34,000**

**Married couple filing jointly: \$32,000 and \$44,000**

Modified Adjusted Gross Income (MAGI) plus interest from tax-exempt bonds\* plus 50% of Social Security benefits is compared against these thresholds. Note that it is "up to" either 50% or 85% of Social Security benefits that are taxed. See page 10 for how the tax is actually calculated.

\*There are additional amounts that must be included in Modified Adjusted Gross Income. Please consult your tax advisor for details.

So wouldn't it make sense that a retiree could take at least twice the amount of his/her income in the form of Social Security rather than in IRA withdrawals before hitting the "trigger point" where Social Security becomes taxable?

Yes. Actually, a double benefit often occurs for those retirees who would otherwise face the taxation of their IRA and Social Security income. Again, think of trading IRA withdrawals for higher Social Security income. Once you reach age 70 and start taking a much higher Social Security amount, you are taking one additional dollar in the form of Social Security income as opposed to IRA withdrawals.

Better still, you do not pay tax on that Social Security dollar "out of the box," which is not true of the IRA dollar. Instead, the Social Security dollar goes into the Combined Income formula at a 50% rate. So, whereas a 25% tax rate applies, the retiree with IRA withdrawals (and lower Social Security income) is paying taxes as follows compared to a retiree who, instead of receiving that dollar in the form of IRA income, receives it in the form of Social Security.

### Figure 3

#### How the combination of IRA income and Social Security income is taxed:

IRA income		\$1
Tax rate	x	25%
IRA tax (A)	=	.25
Additional Social Security subject to tax		\$1
% of Social Security income subject to taxes	x	85%
Taxable Social Security income	=	.85
Tax rate	x	25%
Social Security tax (B)	=	.2125
Total tax in cents (A + B):	=	.4625
Total tax in percentage:	OR	46.25%

#### How every dollar of "delayed" Social Security income is taxed:

Social Security Income		\$1
Combined income formula	x	50%
	=	.50
% of Social Security income subject to taxes	x	85%
Taxable Social Security income	=	.425
Tax rate	x	25%
Social Security tax	=	.1062
Total tax in cents:	=	.1062
Total tax in percentage:	OR	10.62%

## Why this isn't just a tax benefit at the lower income levels

The example in Figure 3 assumes that the higher Social Security income depicted is taxed at the highest amount—85% of benefits. However, in reality, the Combined Income formula calculates the tax on the smallest of:

- 1) 85% of the benefits; or
- 2) 50% of the benefits plus 85% of any excess over the second threshold; or
- 3) 50% of the excess over the first threshold, plus 35% of the excess over the second threshold.

Many individuals will therefore pay little or no taxes when they delay Social Security and take higher Social Security income and lower IRA withdrawals. Usually, this results from #3 above as the least of the three tests. Consider that a married couple could have \$64,000 of Social Security income (counting as \$32,000 in the Combined Income formula) before they would ever have "excess over the first threshold."

Although it is not intuitively clear, it is not just retirees who are near the income thresholds of \$25,000 to \$44,000 who will benefit, but individuals who receive much higher retirement income as well. Prudential's research has found that many individuals with after-tax income up to the mid \$90,000 range, can see significant tax savings from delaying Social Security.

## Why extending tax deferral isn't always the best route

Conventional wisdom has held that it's always better to delay taking withdrawals during retirement from a tax-deferred product (such as an IRA) for as long as possible. However, this frequently does not hold true, as the tax benefits from much higher Social Security make up for any benefits of delaying the receipt of IRA withdrawals.

The example on the next page represents the dramatic drop in Adjusted Gross Income (AGI) in a given year for someone who delays Social Security and therefore earns a higher amount after age 70.

The retiree is trading IRA withdrawals for higher Social Security income after age 70.

- In Approach A, the retiree took Social Security early and is taking IRA withdrawals.
- In Approach B, the retiree took Social Security later, and is therefore taking \$25,000 more in Social Security this particular year and \$25,000 less in IRA withdrawals.

This example is being provided to illustrate the dramatic difference in tax being paid after delayed Social Security benefits begin at age 70. To execute this strategy (Approach B),

larger IRA withdrawals (than Approach A) would have been taken earlier in retirement to allow the retiree to “afford” to delay Social Security.

Looking at a comparison of the income picture after age 70 is very interesting. Even though the same \$90,000 of pre-tax income is provided, Approach B has an AGI of \$35,625 less than Approach A.

In other words, shifting \$25,000 of income to Social Security removed 142% of that amount from the AGI. In total, AGI was reduced by half. Many retirees could see a 75% drop of actual taxes paid when considering both federal and state taxes. This is the Tax Torpedo in reverse.

## Figure 4

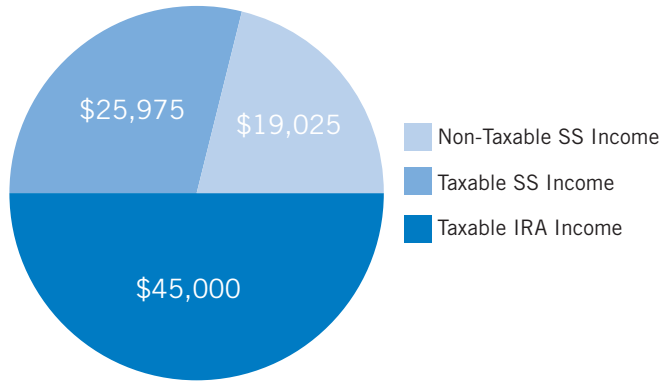
### Example: Tax impact of delaying Social Security payments/Married couple filing jointly

Approach A: Taking reduced Social Security early and supplementing with higher IRA withdrawals  
 Approach B: Delaying Social Security

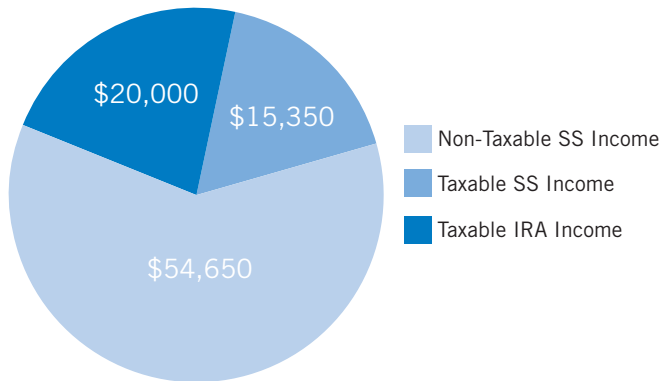
	Approach A	Approach B
Adjustment amount		\$25,000
IRA income	\$45,000	\$20,000
Social Security	+ \$45,000	+ \$70,000
<b>Total pre-tax income</b>	<b>= \$90,000</b>	<b>= \$90,000</b>
AGI	\$45,000	\$20,000
Plus tax-exempt income	+ \$0	+ \$0
<b>Modified AGI</b>	<b>= \$45,000</b>	<b>= \$20,000</b>
Social Security benefits	\$45,000	\$70,000
<b>Test 1</b> 85% of Social Security benefits (Total test 1)	\$38,250	\$59,500
<b>Test 2</b> A) One-half of Social Security benefits	\$22,500	\$35,000
B) Combined income (aka provisional income)	\$67,500	\$55,000
C) Less second threshold	\$44,000	\$44,000
D) Excess above second threshold (B-C)	\$23,500	\$11,000
F) 85% of excess (D x 85%)	\$19,975	\$9,350
<b>Total test 2 (A + F)</b>	<b>\$42,475</b>	<b>\$44,350</b>
<b>Test 3</b> B) Combined income (aka provisional income)	\$67,500	\$55,000
G) Less first threshold	\$32,000	\$32,000
H) Excess above first threshold (B-G)	\$35,500	\$23,000
I) 50% of excess above first threshold (H x 50%)	\$17,750	\$11,500
J) 35% of excess over second threshold (D x 35%)	\$8,225	\$3,850
<b>Total test 3 (I + J)</b>	<b>\$25,975</b>	<b>\$15,350</b>
Amount includable in gross income (Least of the three tests)	\$25,975	\$15,350
Taxable income	\$70,975	\$35,350
Difference		– \$35,625
Percentage of income removed from AGI due to trade of IRA income to Social Security		142.50%
Percentage drop in AGI caused by switch of IRA to Social Security		50.19%

**Figure 5**  
**To Generate \$90,000 of Income,**  
**Which Approach Makes More Sense?**

**Approach A**



**Approach B**



The tax advantages of taking more of your retirement income as Social Security are substantial for many individuals. Conventional wisdom on the “when to start Social Security” discussion has overlooked these tax advantages and must be revisited.

What matters is what the retiree puts in his or her pocket. Higher income in the retiree’s pocket results in a higher quality of retirement and more financial security.

**ROTH ADVANTAGES**

If the retiree already has sufficient after-tax income, the retiree could consider converting other IRA assets into Roth IRA assets. This can be done over a number of years, and the taxes due would be at a lower rate than if he or she had been taking reduced Social Security and higher IRA withdrawals. The conversion of regular IRA assets to Roth assets eliminates the need for those assets to be distributed as Required Minimum Distributions down the road. Retirees can then draw down the converted Roth IRA assets much later in retirement without causing further taxation of their Social Security income. Alternatively, retirees can earmark these Roth IRA assets as a legacy bequest and the beneficiaries can then take tax-free income over their own life expectancies under what is known as the stretch IRA concept.



# Chapter 3: Innovative strategies for divorced spouses, widows, and widowers

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Life doesn't always go as planned. A divorce or the premature death of a spouse may not only result in financial hardship in the short term, but also have lasting effects on retirement security over the long term. Fortunately, Social Security is in place to help. A well thought-out approach can leverage your available options and be the cornerstone of a retirement income strategy.

## IF YOU ARE DIVORCED

The spousal benefit described on page 5 is also available to a former spouse if the marriage lasted 10 years and the individual filing for spousal benefits is currently unmarried. In fact, the “file a restricted application” strategy on page 7 is available as well. One unique twist holds that, if you have been divorced for more than two years, your ex-spouse is not required to have filed for benefits for you to receive spousal benefits. The former spouse merely has to be eligible for benefits (i.e., age 62 and one month). The other strategy discussed, the “file and suspend” strategy, is never needed, since the former spouse does not need to file for benefits for the ex-spouse to become eligible for benefits.

Keep in mind also that it does not matter if your former spouse has remarried. Both current and former spouses have rights to a “full” spousal benefit as well as a “full” survivor benefit.

Let's look at an example to see how the filing of a restricted application might work for a divorced individual. Carla was married to Jay for 18 years and left the workforce for most of those years. Jay and Carla divorced, and Jay subsequently married Maria. Carla returned to work and, years later, is now considering retiring. As a result of her being out of the workforce for a number of years, Carla's Social Security benefit is lower than it would have been had she stayed in the workforce, and is \$1,100 per month at her Full Retirement Age of 66 (her PIA).

Jay's benefit amount at age 66 (his PIA) is \$2,000. One-half of Jay's benefit (\$1,000) would be the potential spousal benefit for Carla. If Carla is retiring and claiming benefits prior to her Full Retirement Age, her worker benefit of \$1,100 at age 66 (prior to any actuarial reductions) is higher than the

potential spousal benefit of \$1,000 (prior to any actuarial reductions), so only Carla's worker benefit would be paid. If she retired at 64 and immediately filed for Social Security benefits, for example, she would receive \$953 per month (a 24-month reduction). She would receive no spousal benefit. (It does not get added when Jay turns 66).

If Carla instead drew down from her IRA account for two years, from age 64 until age 66 and waited to claim Social Security, she likely can create a much better foundation of income. At 66 (or later), she could file only for spousal benefits, delay her own worker benefits until age 70, and then switch over. So Carla would draw monthly income from her IRA account from age 64 to 66. At age 66, Carla files for only a spousal benefit based on Jay's work record and draws \$1,000 per month for four years from age 66 until age 70. Since Carla filed a restricted application for spousal benefits only, her own worker benefit can be delayed and earn Delayed Retirement Credits of 8% per year. When Carla turns age 70, she switches over to her worker benefit which has grown to \$1,452 per month (plus COLAs). By using this strategy, Carla has been able to utilize the spousal benefit (where she wouldn't have otherwise been able to had she started Social Security benefits at age 64) and leveraged it to a higher lifetime payout of her own worker benefit. The manner in which Carla claims her Social Security benefits does not have an effect on Maria (Jay's current wife) and vice versa. Interestingly, Jay will pass on the same survivor benefit to both. Let's assume 20 years has passed—Jay's benefit had grown to \$3,600 per month, Carla's is \$2,600 per month, and Maria's is \$1,800. If Jay dies at that point, both Carla and Maria will step up to Jay's former amount as a survivor benefit and each would receive \$3,600 plus COLAs from that point forward for the rest of their lives.



## IF YOU ARE DIVORCED – KEY POINTS TO REMEMBER

- As a divorced spouse, you have the same rights as a married spouse to a spousal benefit, if married for at least 10 years and you are not currently remarried.
- Unlike a married spouse, you become entitled to a spousal benefit as soon as your former spouse reaches eligibility age, regardless of whether your former spouse has filed for benefits. You have to have been divorced for at least two years.
- If you file for benefits prior to your Full Retirement Age, you will be deemed to be filing for both worker and spousal benefits, and the Social Security Administration will pay you whatever you are eligible for when considering both benefits. The spousal benefit will not increase later to a higher amount.
- You can file a restricted application for only a spousal benefit once you have reached Full Retirement Age. Your former spouse only needs to have turned age 62 (for a full month).
- When you file a restricted application for a spousal benefit, your own worker benefit will grow with Delayed Retirement Credits and COLAs, and you can switch over to your own higher worker benefit at a later age, such as age 70.
- You may step into a survivor benefit based on your former spouse's benefit if it is higher than your own at the time your former spouse passes away. As a result, the longer your former spouse delays the claiming of benefits, the more you may benefit later on in your retirement years.

## IF YOU ARE WIDOWED WHEN YOU RETIRE

Little-known claiming strategies are available for those entering retirement who earned a benefit based on their own work record and also had a spouse who passed away. Conventional financial planning often focuses on taking the higher benefit between the two options. However, there often is a better way, and that is to integrate the two benefits to provide higher lifetime income.

First, consider that a worker benefit becomes available once you have been age 62 for a full month. Therefore, age 62 and one month is typically the earliest age you can start your worker benefit. If you begin benefits prior to your Full Retirement Age, your worker benefits are permanently reduced.

With a survivor benefit, sometimes referred to as a widow's benefit, you can elect to receive benefits as early as age 60. (You do not have to be age 60 for the full month). There are no spousal benefits available to a widow/widower. However, whereas a potential spousal benefit is 50% of the worker's benefit at the worker's Full Retirement Age (the PIA), a survivor benefit is 100% of the deceased spouse's PIA. Survivor benefits are permanently reduced if started prior to Full Retirement Age.

Therefore, if you are widowed coming into retirement and you also worked for at least 40 quarters, you will have a worker benefit and survivor benefit to build your Social Security retirement income strategy. One option is the traditional method, which simply calls for initiating the benefit that provides the greatest monthly value to you when you initially file.

A second option is to start your worker benefit at age 62 and then switch to the survivor benefit at your Full Retirement Age. Frequently, a widowed wife has not accumulated the same level of benefits as a deceased husband, and this strategy allows her to take the highest survivor benefit possible. There are no Delayed Retirement Credits for the survivor benefit so it makes little sense waiting past Full Retirement Age to switch to the survivor benefit.

A third option is to start the survivor benefit at age 60 and then switch to your own worker benefit at age 70. Obviously, benefits under this strategy do not have to start at these ages as they could start later than 60 for a survivor benefit and earlier than 70 for the worker benefit. That said, starting at age 60 allows you to leverage the survivor benefit as early as possible and by waiting until age 70, you allow the maximum Delayed Retirement Credits and COLAs to be applied to your worker benefit.

Let's look at an example, ignoring COLAs for the moment. Lisa is age 60 and was married to Jim for 35 years prior to his death. Both were high earners. Lisa left the workforce for 20

years and then returned to full-time employment. Lisa could receive a full survivor benefit of \$2,400 per month at age 66, or a reduced survivor benefit of \$1,716 per month at age 60. Lisa also has earned a worker benefit, which would be \$1,500 per month at age 62 or \$2,000 per month at age 66 (her Full Retirement Age).

Under the first option, Lisa might choose to take the \$1,716 survivor benefit at age 60. It might appear that this is the best option because not only is \$1,716 higher than her age 62 worker benefit of \$1,500, but she can also start it two years earlier (at age 60). However, Lisa should first consider the other options before making that decision.

With the second option, Lisa could wait until age 62 and draw her \$1,500 worker benefit. She could then switch over to the unreduced survivor benefit of \$2,400 at age 66. If Lisa has the resources from other retirement accounts to provide herself with bridge income from 60 to 62, this method may work very well, since she will be drawing the higher \$2,400 for the rest of her life.

The third option is for Lisa to start her survivor benefit at age 60, while delaying her worker benefit until age 70, and switching over at that point. Thus she would start the survivor benefit of \$1,716 per month at age 60 and then switch to her worker benefit of \$2,640 at age 70. This strategy is the same as the first option, except that Lisa switches over to a higher benefit at age 70. Why wouldn't she choose this strategy as opposed to the first one? The answer is likely that she wouldn't choose this strategy only because she is unaware that this option is available to her.

This example is not to imply that the third option is always best. Any "optimal strategy" depends on the sizes of the worker benefit and the survivor benefit. Further, it will depend on the crossover age (when the lifetime benefits of one strategy surpass another), longevity protection, risk tolerance, and perhaps even taxes.

## IF YOU ARE WIDOWED – KEY POINTS TO REMEMBER

- You may start a survivor benefit at age 60, and/or a worker benefit at age 62, but may not draw both at the same time.
- One option is to draw the survivor benefit early, at age 60.
- Another option is to draw the survivor benefit early, at age 60, and subsequently switch over to your own worker benefit at a later age, such as age 70.
- Another strategy is to draw your worker benefit at age 62 and switch to a survivor benefit at Full Retirement Age.

# Chapter 4: How to bridge the income gap until higher Social Security benefits can begin

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As you can see, there is tremendous potential tax, income, and spousal protection from delaying Social Security benefits and maximizing the use of spousal and survivor benefits.

However, delaying the initial claiming of Social Security benefits doesn't mean you have to delay receiving retirement income. Individuals can tap their IRAs, 401(k)s, or other investments to provide bridge income from the time that they retire until the time that their higher Social Security benefits kick in. There are a number of ways that you can provide yourself with bridge income during this period. Period-certain immediate annuities can provide a consistent cash flow. Alternatively, deferred variable annuities with a guaranteed minimum withdrawal rider work well in providing income streams and often provide more flexibility than immediate annuities. Many 401(k) plans now allow for guaranteed minimum withdrawal benefits or systematic withdrawal capabilities.

Keep in mind that Social Security amounts may change over time for a spouse, as he or she may start a worker benefit at age 62, step up to a higher spousal benefit at age 66, and then inherit an even higher survivor benefit when his or her spouse dies.

If you do decide to delay Social Security benefits, make sure to properly plan by:

- Remembering to maximize possible spousal benefits. If applicable:
  - file and suspend benefits once the primary worker hits Full Retirement Age.<sup>5</sup>
  - utilize the opportunity to file a restricted application only for a spousal benefit once reaching Full Retirement Age.<sup>6</sup>
  - combine the two strategies, with one spouse filing and suspending and the other filing a restricted application for spousal benefits only.

- Comparing potential Social Security start ages on an “apples to apples” basis and treating inflation adjustments fairly. Consider that your annual Social Security statement shows starting amounts at different ages in “today’s dollars,” while almost all financial planning is done in “future dollars.”
- Remembering that the higher Social Security benefit continues when the first spouse dies. No matter which spouse passes away, the smaller benefit will be eliminated.
- Always considering the insurance nature of Social Security retirement benefits, as it provides inflation-adjusted income for as long as you (and your spouse) will need it.

<sup>5</sup>Since this information is not widely known, interested readers can find more information in the Social Security procedures manual known as the Program Operations Manual System [POMS] under section GN 02409.100 and GN 02409.110. The public version of this information is available on the Internet at <https://secure.ssa.gov/apps10/poms.nsf>. Similar information is available on how to file a restricted application for spousal benefits at Social Security POMS section RS 00202.025 and RS 00202.020.

<sup>6</sup>Information on how to file a restricted application for spousal benefits can be found in the Social Security POMS sections RS 00202.025 and RS 00202.020.

## CONCLUSION

The safety and comfort of guaranteed lifetime income provided by traditional defined benefit pensions may be fading away, but future retirees can use the flexibility afforded by their 401(k) and IRA balances to help optimize and maximize the guaranteed lifetime benefits of Social Security. In fact, many future retirees may find even greater advantages than if they had a traditional pension, due to the tax advantages of higher Social Security benefits, as their traditional pension income may have subjected them to the Tax Torpedo.

It truly has become a “Do-It-Yourself” retirement world. However, retirees who employ a strategy that can withstand the risks they’ll face will have a better chance of enjoying a happier retirement. It is all about choices. Those who understand how to evaluate their choices and optimize their decisions will be the ones to enjoy a more secure retirement. A larger amount of Social Security within a retirement income strategy may, indeed, be the golden ticket to the golden years.



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