Five things you need to know about optimizing Social Security

Most people plan to rely on Social Security for retirement income. And the statistics bear that out. Social Security benefits already provide more than half of retirement income for 50% of couples and 71% of individuals.*

Those preparing to retire may not understand the different ways to claim Social Security and, depending on their individual financial situations, the strategies to consider for optimizing their benefit amount.

A guaranteed source of income may mitigate risks

Planning for income in retirement involves many variables and risks at the individual level, such as longevity and income, as well as macroeconomic factors, such as inflation, fluctuating markets, and taxes. While Social Security is not the single solution for all of these issues, it may mitigate these risks by guaranteeing a stream of income that is not tied to market performance.

In the past few decades, Americans have seen a dramatic difference in the retirement experience. Today, people are living longer and workers need to plan for 25 to 30 years in retirement, a much longer time horizon than for past generations.

At the same time, the retirement investment landscape has changed. Pension plans, once a source of retirement income for many workers, are now offered by far fewer employers. The defined contribution, or 401(k) plan, has become the most common offering in the workplace. Consequently, plan participants have taken on more responsibility for managing their retirement savings and planning for income in retirement.

Guaranteed income, like Social Security, can act as a stabilizing factor in market downturns. While variable retirement savings vehicles can lose money in a market decline, a guaranteed source of income can offer consistency and may help clients avoid liquidating other investments to meet expenses.

Social Security also carries tax advantages that other forms of retirement savings, like Individual Retirement Accounts, do not offer. Some retirees will receive benefits free of taxes.

The bottom line is that Social Security can be an important part of a retirement income plan because it provides a lifetime stream of guaranteed income that is not dependent on markets and also adjusts periodically to keep pace with inflation.

Fundamentals of Social Security

Eligibility	At least 40 quarters of work
Individual contributions	Social Security payroll tax of 6.2% on first $128,400 of earnings
Benefits	Calculated based on average monthly earnings indexed for inflation
Retirement age	Reduction in benefits before full retirement age (currently 66), increase in benefits if delay (up to age 70)
Early retirement	Available at age 62 with 25% decrease in benefits
Spousal benefits	Spousal benefit (50% of covered spouse's benefit) and survivor benefit (100% of covered spouse's benefit)

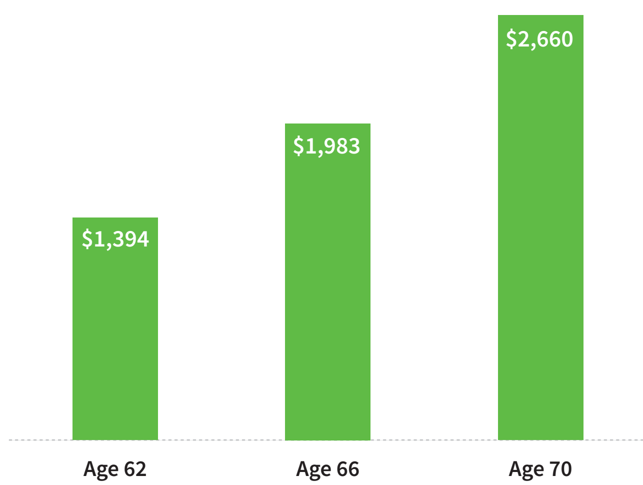
* Social Security Administration, Fast Facts & Figures About Social Security, 2017.

Timing makes a big difference

While available to millions of workers, it is not a one-size-fits-all plan because many variables influence Social Security benefits. It is important to make the right decisions in order to mitigate the risks of longevity and inflation. Understanding how Social Security benefits are calculated is important, and identifying the opportune time to file a claim can have a major impact on financial success in retirement. The following are five essential things to know about determining a strategy for Social Security benefits.

1. Claiming benefits too early can cause problems

One of the greatest challenges for savers is estimating their longevity. Some savers are likely to outlive their retirement nest egg.



Source: Social Security Quick Calculator benefit estimate based on an individual age 62 with $75,000 in current earnings. Does not include increases in benefit levels due to regular cost-of-living adjustments.

However, the more common problem is not living beyond life expectancy, but claiming benefits too early. This reduces the income potential of full benefits. About 75% of workers sign up for Social Security before reaching full retirement age. At this point, the benefit is significantly lower and may be more likely to be subject to taxation for those still working.

Waiting can help. By delaying the start of Social Security benefits, retirees will receive more money. In essence, they receive an 8% "raise" for every year they delay taking benefits.

Once you claim your benefit, you are generally locked into that benefit amount, unless you change your mind within 12 months of starting benefits and withdraw your request to begin. If this request is approved, you must repay all the benefits you and your family have received based on your retirement application.

If you are still working, the timing of your claim can have an impact on the amount of Social Security benefits you receive. For 2018, your Social Security benefits are reduced by $1 for each $2 in earnings above $17,040.† If you claim benefits at full retirement age or older, there is no limit on the amount you can earn by working in retirement.

2. Plan for your surviving spouse

It is important for couples to consider longevity when planning for the surviving spouse. Historically, higher-earning spouses have taken Social Security early, without maximizing the benefit potential. This strategy exposes the surviving spouse to longevity risk of receiving a lower benefit if the higher earning spouse dies first. When making the decision to claim Social Security, think about joint life expectancy. If possible, maximize the highest earner's benefit to provide a higher lifetime benefit for the surviving spouse.

Determining the best time to apply for Social Security benefits also depends on a couple's financial and tax situation, age difference, and life expectancy. It can be an important discussion for clients to have with an advisor so that they understand that claiming benefits early can affect not only the monthly benefit amount, but also the benefits received by the spouse, and, ultimately, the survivor benefits.

Because of the availability of Social Security spousal benefits, married couples have more choices of how they claim Social Security in retirement. Spouses can claim benefits at different times, which may enable them to take advantage of higher benefits if claims are delayed, resulting in an increase in lifetime and survivor benefits as well.

† This earnings test applies in years before attaining full retirement age. A higher earnings amount ($45,360 for 2018) applies during the year of attaining full retirement age. If retirement benefits are withheld because of earnings, benefits will be increased starting at full retirement age to take into account the benefits that were withheld.

Restricted application strategy still available

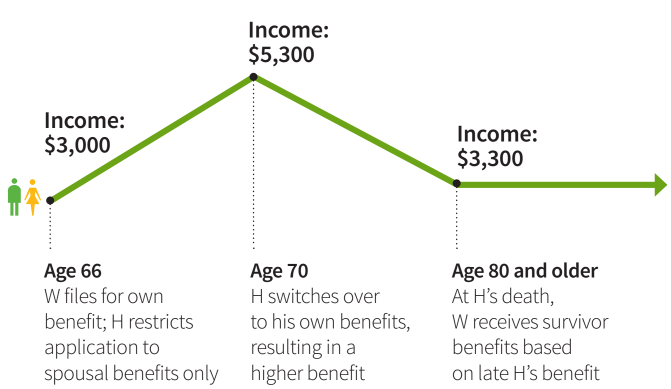
The Bipartisan Budget Act of 2015 eliminated two options on how married couples can claim Social Security retirement benefits. One strategy, known as "file and suspend," was eliminated effective April 30, 2016. The other strategy, "restricted application," is being phased out over a number years. Those who reached age 62 in 2015 can still use this strategy when they reach full retirement age (66).

The restricted application strategy can be an effective option for a married couple when both spouses have similar earnings records and are looking to address longevity and inflation risk. First, the lower-earning spouse typically files for retirement benefits at full retirement age. This allows the higher-earning spouse to restrict his or her application for spousal benefits only while delaying his or her own retirement benefits (preferably to age 70 if possible).

Workers who can delay taking their benefits have an advantage because the monthly benefit increases until age 70 by 8% each year. At that age, workers can file to receive their individual benefits at the highest monthly amount. This strategy also preserves the highest possible survivor benefit to help the surviving spouse maintain his or her standard of living.

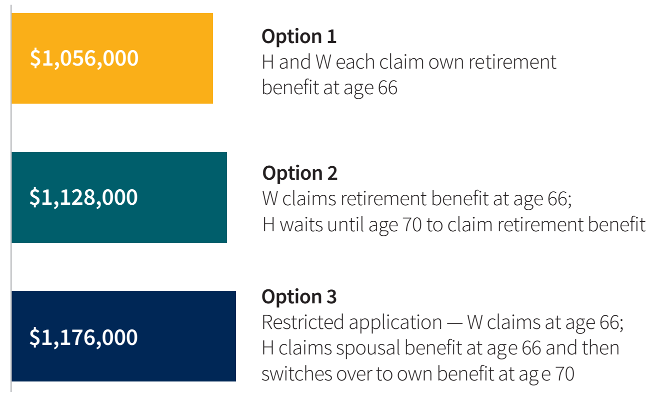
Restricted application strategy may benefit couples

Consider this example where both spouses are the same age, with similar earnings history, and the retirement benefit for the wife (W) at full retirement age is $2,000 and the benefit for the husband (H) is $2,500. We assume that the husband passes away at age 80 while the wife lives to age 90. In this case, utilizing the restricted application strategy may yield more lifetime income for the couple.



Using the same example, here is a look at how the restricted application strategy would provide more total income over the lifetime of the couple as compared with other options.

Claiming options and total life income



Note that this is a simple, hypothetical example. Many situations for couples are more complicated, especially if age between them differs. For that reason, it's important to consult with a professional who has access to a comprehensive Social Security software program to determine the most favorable claiming strategy based on different assumptions (age, retirement benefit, and longevity).

3. Special rules for divorced and widowed individuals

Divorced individuals may receive benefits based on the ex-spouse's earnings record. There are certain conditions that must be met:

- The marriage lasted 10 years or more
- The ex-spouse is eligible for Social Security benefits (even if he or she has not filed for benefits yet)
- The spouse making claim on the ex-spouse's record is unmarried and age 62 or older

Unlike spouses or ex-spouses, widows may receive benefits as early as age 60. However, the benefit amount for beginning benefits that early would be 71.5% of the full amount and is based on the deceased spouse's earnings. The longer benefits are delayed, the greater the amount. However, unlike retirement benefits, survivor (and spousal) benefits do not increase if claimed after full retirement age.

Lastly, survivor benefits are lost if you remarry prior to age 60, unless that marriage ends in divorce or death.

4. Social Security is likely to be taxed

For retirees with moderate or higher incomes, it is likely that some portion of benefits will be taxed. Depending on the income level, up to 85% of benefits may have to be reported as taxable income.

Income level*	Taxation
Between $25,000 and $34,000 *($32,000 and $44,000 for couples)*	Up to 50% of benefits reported as taxable income
Over $34,000 *($44,000 for couples)*	Up to 85% of benefits reported as taxable income

* IRS Notice 703. Income calculation for taxation of Social Security benefits equals your adjusted gross income (AGI), one half of Social Security benefits, and tax-exempt municipal bond interest. Income from Roth accounts does not negatively impact taxation of Social Security benefits.

5. Pension income may reduce benefits

Public employees, such as school teachers, slated to receive a pension may face challenges if they hope to include Social Security in their retirement planning. If an individual works in a job that does not withhold Social Security payroll taxes, receiving a pension may result in the reduction or elimination of his or her Social Security benefits.

Social Security has two provisions — the Windfall Elimination Provision (WEP) and Government Pension Offset (GPO) — that address situations where an individual has worked multiple jobs in both the public and private sectors, and is looking to claim spousal and survivor benefits.

Windfall Elimination Provision

The WEP ensures that workers with multiple types of jobs are treated the same as government workers in jobs that did not pay into Social Security. Under this provision, Social Security benefits may be reduced but not totally eliminated.

Prior to the WEP, those who worked primarily in a job not covered by Social Security, but who had some employment history with a job that was covered, were considered long-term, low-wage workers and received a Social Security benefit based on a higher percentage of their earnings.

Government Pension Offset

The GPO provision may affect individuals who earned a pension where the employer did not withhold Social Security and who are now applying for Social Security *spousal* or *survivor* benefits based on the spouse's earnings history. In this case, benefits are reduced by two thirds of the amount of the pension income. For example, consider a retiree who receives a public pension of $750 per month and applies for Social Security spousal benefits. The monthly check for Social Security spousal benefits would be reduced by two thirds of the monthly pension amount, which in this case would be $500.

Clients should seek to maximize their benefits

Social Security is a critical component of an effective retirement income plan. Many investors — across all income levels — will include Social Security as a source of retirement income.

Understanding and making the right decisions around claiming Social Security can be a big driver of success in retirement and can translate into thousands of dollars of benefits over time. Seeking professional advice can be a vital aspect in the planning process, and a financial advisor can help individuals and couples understand the different ways to claim Social Security and try to maximize benefits.

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