Gaming Social Security
Increasingly sophisticated retirees are figuring out how to get the most out of the system.

By Linda Stern | Newsweek Web Exclusive
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Conventional wisdom says that workers should hold off as long as possible before claiming their Social Security benefits. Every month they hold off until they reach age 70 means a fatter monthly check over the long term.

But now, experts and some sophisticated seniors are looking deeper into the finer points of the program and finding other strategies that can optimize retirees' benefits. Researchers at Boston College's Center for Retirement Research, for example, have devised a number of strategies according to which retirees can share spousal benefits, refund, and then restart their benefits, or claim and defer their monthly checks. All of these strategies are aimed at improving the bottom line—"winning" the Social Security game, so to speak. "Planning for Social Security is like an investment decision," says Robert Carlson, a Fairfax, Va., financial adviser and editor of the Retirement Watch newsletter. "You really need an individualized analysis and to see the specific numbers to decide which [approach] gives you the biggest payoff."

Today, the full retirement age for claiming Social Security benefits is 66. Anyone can start taking benefits at 62, but those who do will get a monthly benefit that is 25 percent lower than what the full benefit would have been at 66. Waiting longer than 66 increases the benefit by 8 percent a year. (Workers can find their own expected benefits at the Social Security Administration's Web site.) By the most simplistic analysis, anyone who expects to live beyond their early 80s typically would maximize benefits by deferring the start date.

But other factors affect that decision as well. The average age at which recipients first claimed their benefits in 2008 was 63 years and 6 months, only slightly higher than the all-time low recorded in 2006, of 63 years and 4 months. Not everyone who stops working before 66 can afford to defer benefits until the full retirement age. "Some people will take the money as quickly as they can because they are worried that Social Security will disappear and there will be no benefits," says Frank Todisco, a senior pension expert with the American Academy of Actuaries. "But that is a distorted view. There are financial shortfalls predicted, but the program is not going to disappear. The key financial risk for recipients is the longevity risk, the risk of living too long." Retirees who start collecting smaller benefits earlier may be able to insure their end-of-life cash needs by buying a
deferred annuity or long-term-care policy with some of their monthly benefits.

Then there's the tax issue. Social Security benefits are taxed based on the recipient's total earnings. "This has a distorted effect on your taxes," says Todisco. "It can throw you into an abnormally high tax bracket." Half of Social Security benefits are taxed as ordinary income for people earning more than $25,000 in a year ($32,000 for couples). Once income exceeds $34,000 ($44,000 for couples), 85 percent of the benefits is considered taxable. That increases the recipient's marginal tax rate by 85 percent, reckons Todisco, and means that retirees who expect to be in high tax brackets and who would have to depend on significant withdrawals from tax-deferred accounts to delay taking their Social Security benefits might be better off getting reduced benefits sooner.

Finally, there are other wrinkles in the way Social Security is doled out that offer opportunities to crafty recipients. Retirees who have other savings to live on can claim their Social Security benefits at 62, live on their savings and invest those benefits, and then, when they turn 70, withdraw their Social Security application, pay back the total amount they received in benefits (not counting the interest that money has earned) and start at the newer, higher benefit they would receive at 70. "This is like getting a free loan from the Social Security Administration," says Avram Sacks, a Social Security legal analyst with CCH, a tax research firm. For example, a person claiming a reduced benefit of $1,000 a month at 62 will have received $96,000 by the time he turns 70. But if he were to invest that money each month in an account earning 8 percent, he would have earned an additional $37,870 by 70. At that point, he can pay back the $96,000 in benefits received, start claiming a new benefit of $1,892 a month, and still have $37,870 in the bank.

Why wouldn't everyone do that? Not everyone can afford to save and invest while they are collecting Social Security. And there's no guarantee that Congress and the Social Security Administration won't close that loophole, not to mention the potential risks of investing.

The Boston College group has devised other money-saving strategies for recipients. Couples who have very disparate incomes (such as a high-earning husband and a wife who mostly did not work for pay, or earned little), can benefit by having the wife start her benefits at 62 and the husband delaying his benefits as long as financially possible. Once he starts claiming benefits, she can give up hers and start claiming a spousal benefit under his account. That would give her a total of 50 percent of his benefit. That strategy works as long as the low-earning spouse's expected Social Security benefit is no more than 30 percent of the high-earning spouse's benefit.

There's a strategy for couples with roughly equivalent expected benefits, too. "The way an optimizing couple would use 'claim now, claim more later' is for the wife to claim at 62 and, once her husband reaches age 66, he would claim a spouse's benefit based on his wife's earnings," writes the Boston College group. "At age 69, he would claim the maximum amount of his own retired worker benefit due to the delayed retirement credits, and stop receiving the spousal benefit. Of course, if the woman is the higher earner, the story works in reverse."

Those strategies add a lot of complexity and uncertainty to what's already a complicated decision. Older workers probably would be justified in hiring their own actuary or Social Security-savvy accountant to
play what-if games for them so they can maximize their benefits or, even more important, keep more money for later life. But while you're crunching those numbers, you should remember this: The real answer probably doesn't lie in a formula, but in a life plan. Most experts agree that anyone who's still happy working would do best to just back away from the calculator and keep on keeping on. The later, bigger benefit will just be a bonus.

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