Is Time Running Out on Social Security?

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Abstract

While Social Security is a significant income source for many retired Americans, the program is struggling with funding. Many industry experts have suggested that the influx of new Social Security claimants, in addition to the reduced income from fewer people working, may cause the Social Security system to run out of funds even faster than initially projected. Accordingly, many retirees are considering claiming Social Security benefits early.

Read on to learn how the possibility of benefit cuts is not reason enough to suggest that people claim Social Security early, why Social Security will continue to be an essential retirement income stream, how claiming early can leave a lasting negative impact for many people, and what financial advisors can do to alleviate client concerns, communicate the value of a sound Social Security claiming strategy, and optimize clients' Social Security claiming strategies.

SOCIAL SECURITY HAS BEEN A SIGNIFICANT INCOME SOURCE FOR MANY RETIRED AMERICANS.

Social Security Basics

In 1935, President Roosevelt signed the Social Security Act. The legislation outlined a social insurance program that was designed to give Americans age 65 or older an additional income stream in retirement. The Social Security program has consistently evolved over time to adapt to the changing needs of the American people.

Let us take a closer look at how the Social Security system functions. American workers pay taxes into Social Security to provide benefits to those who are eligible right now.

Generally speaking, the amount one receives in Social Security retirement benefits is reduced or increased based on when benefits are claimed relative to full retirement age (FRA). For instance, someone born between 1943 and 1954 would receive $1,500 at their FRA of 66. If this individual claimed early at age 62, they would receive $1,125 per month, but by delaying until age 70, they will receive $1,980 — a 76% increase in the monthly benefit amount. The last of this group reached full retirement age in 2020.

It is important for people born after 1954 to note that the full retirement age is based on their year of birth. For example, someone born in 1955 has an FRA of 66 years and two months, and someone born in 1956 has an FRA of 66 years and four months. Each birth year up to 1960 increases FRA by two months. Those born in 1960 and beyond have an FRA of 67. Even with FRA changes, the relationship between claiming early and delaying is roughly the same — a 77% increase.

For those born in 1960 or later, the full retirement age is 67. Claiming at age 62 would result in a monthly benefit of $1,050 compared to $1,860 a month for those claiming at age 70.

A Variety of Other Considerations

If one examined a Social Security benefit on its own, determining when to claim might seem relatively straightforward. However, most people have multiple sources of income in retirement, which can impact the decision about when to claim Social Security. It is also critical to consider the impact of an additional Social Security benefit. A spouse's or widow's benefit option can make a big difference when it comes to deciding when to claim. When one considers that many retirees underestimate their own longevity and the impact of all the different interactions caused by additional benefits and multiple retirement income streams, the decision can get considerably more nuanced.

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Social Security Claiming Strategies for Couples

When crafting a Social Security claiming strategy, it is essential to keep in mind the effect a spouse's or ex-spouse's Social Security benefit may have on the claimant. Spousal benefits may seem relatively straightforward — a spouse is entitled to the higher benefit on their earnings record or 50% of the benefit on the spouse's earnings record. Nevertheless, the differences between spousal benefits and benefits on the claimant's record can be significant.

Spousal benefits are reduced on a faster schedule. Someone whose full retirement age is 66 and who elects retirement benefits at 62 will get 75% of the FRA benefit. Claiming a spousal benefit at age 62 would result in a check that is only 70% of the full spousal benefit. Also, spousal benefits do not get the additional 8% per year for delay past FRA.

Spousal benefits are not just available to people who are currently married. They are also available to divorced spouses who qualify. One has to have been married for 10 or more years and cannot be currently married, and the benefit amount is the same as it would be for a current spouse. The ex-spouse under whose earnings record one is claiming can be remarried, but the claimant must not be remarried for the claimant to qualify for this benefit.

The main difference when filing for divorced spousal benefits is the concept of "independent entitlement." Someone who has been divorced at least two years is considered to be independently entitled, which allows them to claim if the ex-spouse was at least age 62. The ex-spouse does not need to have claimed and could even be precluded from claiming by current work that is over the amount allowed by the Retirement Earnings Test.

The spousal benefit is not affected by an ex's current spouse or any dependents. The biggest challenge in planning for divorced spousal benefits is that the claimant may not know when the ex will file. There are a few things to consider.

- If the ex-spouse files late, will that create a survivor benefit more generous than the client's own benefit or not?
- If the ex-spouse files early, will that benefit be greater than the claimant's own benefits? Pay attention in case a survivor benefit becomes available later.

Restricted Application

Filing a restricted application is one technique that can be incredibly beneficial for those born before January 1954. For example, say Jeremiah has a benefit of $2,500 at FRA, and Judy has a benefit of $1,500 at FRA. Judy files at age 63, taking a reduced benefit. When Jeremiah reaches full retirement age, he files a restricted application for only spousal benefits, which allows him to take only his spousal benefit based on Judy's earnings. His benefit continues to earn delayed retirement credits until age 70. Then, at age 70, Jeremiah switches to his benefit of $3,300 a month. The restricted application allowed Jeremiah to collect $750 per month for 48 months while still getting all of his delayed benefits. That's more than $36,000! Note the birth dates associated with this strategy; the last group to be eligible for the restricted application will turn 70 on January. 1, 2024.

Split Strategy

Many retirees need the cash flow from Social Security to come in sooner because of liquidity challenges or a health situation. If a client needs cash flow sooner, it can often make sense to do what one might call a "split strategy." The higher wage earner still delays, but the lower wage earner claims early in this strategy to ensure that the couple's surviving member receives the highest possible survivor benefit. In this case, a split strategy gets cash flowing into the household sooner and potentially reduces the strain on other assets.

MANY RETIREES NEED THE CASH FLOW FROM SOCIAL SECURITY TO COME IN SOONER.

Widow(er) Benefits

Following a retired worker's death, a surviving spouse may be eligible for survivor benefits calculated based on both when the deceased claimed Social Security and when the survivor claims. The benefit is limited to the higher of 82.5% of the deceased's FRA benefit or the amount the deceased was receiving at the time of their death. If the deceased was born between 1943 and 1954 and claimed benefits at age 62, and the surviving spouse reached full retirement age by the time of the deceased's death, the surviving spouse will receive more than the deceased was receiving (82.5% of the deceased's FRA benefit rather than 75%). The numbers are not round for people with FRA greater than 66, but the concept is the same.

The best claiming strategy to prepare for eventual survivor benefits will vary significantly based on several factors such as age, health, earnings and more. For instance, if the older spouse is a significantly lower wage earner and is in poor health, claiming retirement benefits as early as possible often makes sense. However, when the survivor is younger than the deceased and the deceased was the higher wage earner and had elected early benefits, delaying the widow(er) benefit to the widow(er)'s FRA may result in months of forfeited checks without a corresponding increase in benefits.

Widow Benefits Case Study

William was born on Jan. 2, 1956. He had an FRA benefit of $2,500. He claimed benefits at age 62. When he died at age 64 in January 2020, he was receiving $1,833. Therefore, the "widow limit" is $2,062 (82.5% of $2,500).

Whitney was born on Jan. 2, 1958. Her FRA benefit is $1,500. If she claims her benefits early at age 62, she will get $1,075 per month. If she delays until age 70, she will receive $1,900 per month.

Whitney has a few options. If she claims her retirement benefit at age 62, she will receive $1,075 until she switches to her widow benefit. When she files for Medicare at age 65, Social Security personnel may switch her over to the $2,062 widow benefit; however, that option would cost her almost $30,000 in forfeited benefits.

Widow benefits operate on a straight-line reduction of 28.5% divided by the number of months between age 60 and widow(er) FRA. Whitney has 76 months between her initial widow(er) benefit eligibility at age 60 and her widow(er) FRA of 66 years and four months. Her widow(er) FRA is four months earlier than her own retirement benefit FRA of 66 years and eight months. In this case, each month of delaying the widow(er) benefit results in a 0.375% increase. The maximum widow(er) benefit Whitney can receive is 82.5%. Whitney would need to delay for 29.33 months to get from 71.5% to 82.5%. Her widow(er) benefit only grows for the first 29 months because of the widow(er) limit. After 29 months of delay (beginning at age 60), the widow(er) benefit is capped at $2,062. By not knowing the rules, Whitney would forfeit 31 months of widow benefits or $30,597.

Let us say that she instead filed for widow(er) benefits at age 62. She would receive $2,012 per month, and she would not switch to her retirement benefit because, at the most, her retirement benefit would only have grown to $1,900 per month. There is no significant difference from what she would have received if she delayed five more months; however, she will break even at seven years and 10 months. If Whitney lives past age 70, she will forfeit $600 per year plus cost of living adjustments (COLA) for the rest of her life — a several-thousand-dollar mistake.

Unfortunately, widow benefits are one of the most regularly missed considerations by Social Security personnel, so the mistake might go unnoticed. Retirees who have options for coordinating their retirement benefit with a survivor benefit should consider bringing on a knowledgeable and equipped professional with appropriate tools for navigating the complexities of survivor benefits.

The Taxation of Social Security

Taxes on Social Security benefits are determined using the provisional income formula. “Provisional income” includes half of Social Security benefits plus all other taxable income — including dividends, realized interest, and realized capital gains — plus nontaxable interest earnings, such as from municipal bonds. The formula has different thresholds based on whether one is single or married. For those who are considered upper-middle income or upper income, 85% of a Social Security benefit is often taxable, and 15% is tax-free.

Let us say a married couple filing jointly has $50,000 of total income, and none of it is “tax-free” (e.g., Roth withdrawals or return of principal). It might appear at first glance that 85% of their Social Security benefits will be taxable. However, the chart below shows a step-by-step breakdown of the provisional income formula, and only 27.27% of the client’s Social Security benefits will be taxable as ordinary income.

THE FORMULA HAS DIFFERENT THRESHOLDS BASED ON WHETHER ONE IS SINGLE OR MARRIED.

Step 1: Provisional Income	$40,000 in Social Security benefits (1/2 is $20,000) **+** $30,000 in IRA withdrawals **=** $50,000 of "Provisional Income"
Step 2: First Threshold	$50,000 in Provisional Income **-** $32,000 (first threshold for married) **=** $18,000 above the first threshold **x .5** **=** $9,000 of taxable benefits
Step 3: Second Threshold	$50,000 in Provisional Income **-** $44,000 (second threshold for married) **=** $6,000 above the first threshold **x .35** **=** $2,100 of taxable benefits
Step 4: Add	$9,000 **+** $2,100 **=** $11,100
Step 5: Check the Max	.85 **x** $40,000 (total social benefits) **=** $34,000 If Step 4 is less than the max, Step 4 is the taxable amount. If Step 4 is greater than the max, then Step 5 is the taxable amount.

Source: https://www.covisum.com/blog/calculator-figures-social-security-tax

In short, Social Security carries a substantial tax advantage over other forms of income, so delaying benefits in order to build a more considerable Social Security benefit has a more significant positive tax impact than most people realize.

The Future of Social Security

It is no secret that the Social Security system is facing challenges, and people are nervous. In fact, with the pandemic causing record-high unemployment numbers and fewer people paying into the system, many have estimated that the Social Security program will run out of funds even faster than initially projected in the last Social Security Trustees Report.

However, it is essential to know that changes to the system have occurred regularly throughout history — often with a minimal negative impact on current retirees. Historically, when the United States has struggled with Social Security challenges, legislation has been drafted to address these issues.

In 1983, when the Social Security system was on the brink of collapse, there was a complete overhaul of Social Security benefits. The overhaul raised the full retirement age for future retirees from 65 to 67, changing the structure of delayed retirement credits and creating taxation on Social Security benefits. (Before 1983, benefits were tax-free.)

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Also, the second tier of taxation was created in 1990. Changes to the earnings test were enacted in 2000. In 2015, claiming rules specifically for married couples and divorced individuals changed, limiting the ability to withdraw an application, preventing spousal and children's benefits from being claimed during a benefit suspension, and eliminating the restricted application for people born on or after January. 2, 1954. There is significant precedent for making changes to the system to shore up the program financially.

The magnitude of the changes required are not trivial but also are not insurmountable. Even if no changes were made, the system would still be able to pay 76 cents of each promised benefit dollar based on then-current tax revenue. In short, people should not elect early out of fear that Social Security will not be there. The more likely scenario would be benefit cuts.

Potential Benefit Cuts

Historically, most changes have been phased in over time to minimize the impact on current retirees. Let us take a closer look at some of the changes that have been proposed in different variations over time and their potential impact.

The first is increasing the payroll tax. Currently, the worker pays 6.2%, and the employer pays 6.2% for 12.4% total payroll tax. Those who are self-employed pay the full 12.4%. Increasing the payroll tax by 1.6% for both the employee and the employer could fully fund the system.

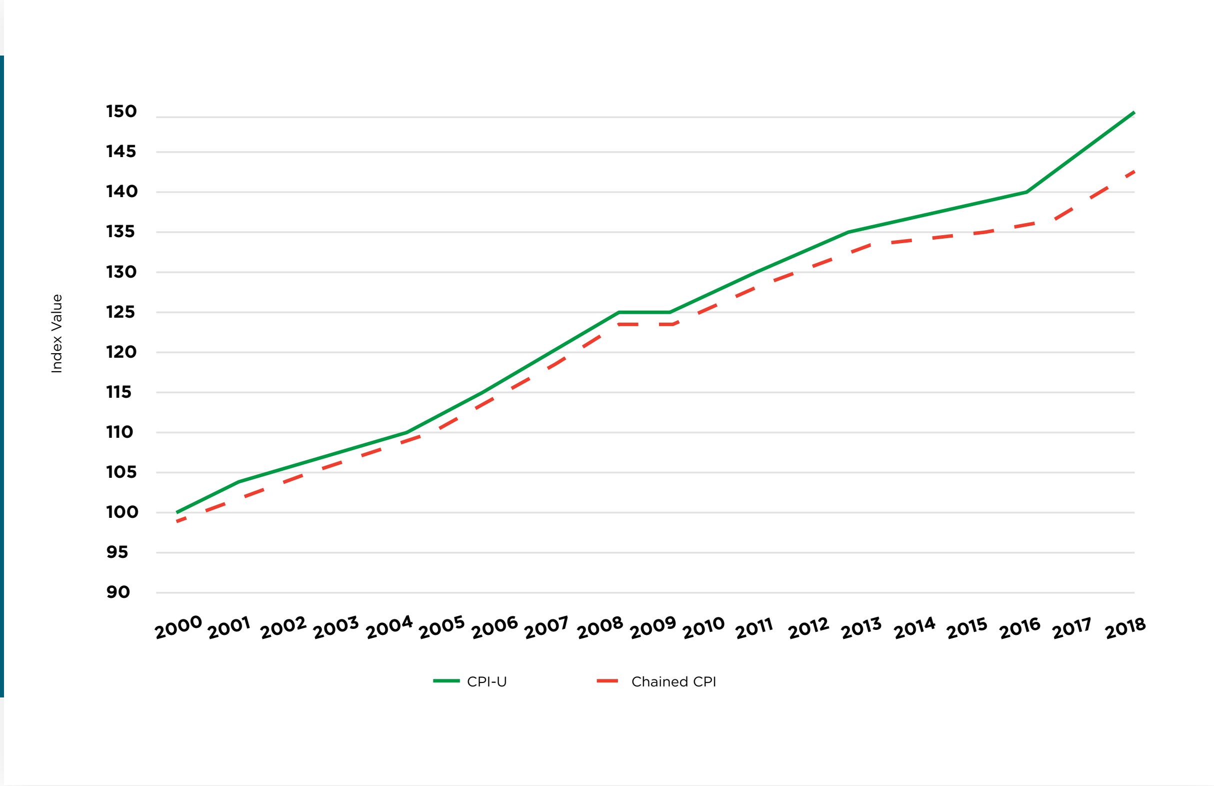
A second potential change would be to increase the full retirement age for younger workers. Increasing the FRA in this way is a form of cut that was first introduced in the 1983 amendments. At that time, FRA was 65. The 1983 amendments phased in an increase to age 67 for those born in 1960 or later. If this change came to fruition, it would probably occur much as it has in the past for retirement ages, with a bigger penalty for younger people claiming early.

A third change would be to increase the earnings cap. Up to about $140,000 (indexed annually) of earned income is taxed for Social Security benefits, increasing each year. If the cap were removed and no other changes were made, the system would be fully solvent. Part of President Biden's tax plan would create a "donut hole" where the first $140,000 is taxed for Social Security, and any income over $400,000 is also taxed for Social Security. It remains to be seen whether this proposal will be implemented, but it will receive consideration.

It is important to note that none of these changes represent a benefit cut to those already receiving or close to receiving benefits.

Chained Consumer Price Index (CPI)

One change will likely happen that will impact people who are already taking benefits: making a shift to chained CPI. As costs increase, buying habits change.



Source: https://www.bls.gov/news.release/pdf/cpi.pdf

The chart above shows the impact of chained CPI since its inception. It reduces the amount a benefit will go up over time. Simultaneously, even with chained CPI, Social Security would provide an excellent hedge against rising prices, particularly in this economic environment.

A final possibility — though history would suggest it is unlikely — is that there will be no reform, and the Social Security trust fund will be completely depleted. Were that to happen, a 24% benefit cut would be applied to all beneficiaries.

CPI Case Study

Let us look at a case study. Agnes is a 62-year-old in average health. By claiming at 62, she will receive full checks for a full nine years before experiencing a benefit cut if she claims early. She will experience the benefit cut shortly after electing if she delays to age 70. In raw dollars, the same benefit cut percentage applied to a delayed benefit would be substantially more extensive than the benefit cut applied to a benefit that was claimed early. Even if Agnes received a full 24% cut in 2029, she would still be substantially better off by age 85, and she has a 64% chance of living that long.

Age at Death	Probablity of Survival	Benefit Cut by 24% in 2035		Benefit Cut by 24% in 2029	
		Value of Claiming at 62	Value of Claiming at 70	Value of Claiming at 62	Value of Claiming at 70
75	88%	$234,673	$174,921	$214,918	$140,065
80	78%	$299,896	$290,197	$276,238	$248,383
85	**64%**	**$360,004**	**$396,432**	**$336,346**	**$354,618**
90	44%	$418,924	$500,568	$395,266	$458,754
95	23%	$476,680	$602,645	$453,021	$560,831

Notes:
- Lifetime value of Social Security benefits based on various ages of death
- Survival probabilities based on longevityillustrator.org for a 62-year-old, non-smoking female in average health
- Real discount rate of 0.4%

What is most important to remember is that claiming Social Security early is not ideal for most people. Of course, every situation is different, but the last thing any financial advisor wants is for their clients to make a poor retirement decision out of fear. A reasoned decision that considers the client's longevity, additional retirement income, the potential for multiple benefits, and all the other factors outlined above can add thousands of dollars to a retirement strategy.

This calculator shows the impact of Social Security benefit cuts.

How Social Security Timing Can Help

As the first patented Social Security optimizer, Social Security Timing® has helped financial advisors highlight the value of a sound Social Security claiming decision for more than 10 years. With Social Security Timing, financial advisors can help optimize clients' Social Security claiming strategy. See the exact year and month the client should claim, and see the month, year, and the amount that the client will receive when they pass the earnings test.

Subscribers also receive access to an on-demand "Social Security and Retirement Income" webinar marketing kit that includes everything you need to promote and host the included seminar or webinar, as well as follow up with attendees. Subscribers will get exclusive access to the "Social Security and Retirement" PowerPoint, on-demand video series, email templates, social media share graphics, and so much more.

Optimize your clients' Social Security claiming strategy and increase their retirement value with Social Security Timing.

FINANCIAL ADVISORS CAN HELP OPTIMIZE CLIENTS' SOCIAL SECURITY CLAIMING STRATEGY.