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IRA Focus

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ANALYSIS

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Understanding Social Security Benefits in Retirement

Social Security benefits are one of the cornerstones of many clients' retirement plans. The benefits are backed by the federal government, are guaranteed for life, and receive cost-of-living adjustments to help aging clients keep up with the cost of inflation. As such, advisors must have at least a basic understanding of Social Security benefits and how they work in order to properly guide clients.

Who Is Entitled to Social Security Retirement Benefits?

In general, there are only two requirements for a client to be eligible to receive Social Security retirement benefits. They are as follows:

- **Be Age 62 or older –** As covered in greater detail below, the earliest a person can collect Social Security retirement benefits is 62 but they will be reduced.
- **Have 40 or more credits –** Each year, clients can earn up to four credits. Contrary to widely-held views and although up to four credits can be earned each year, these credits are not earned "quarterly." Rather, they are based on the amount of income a client earns each year. For example, in 2016, a client will earn one credit for every $1,260 they earn, up to the maximum of four credits. Thus, a client with just 10 years of a relatively modest earnings history may be entitled to receive Social Security retirement benefits.

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While the rules above are the basic rules that determine if a client is entitled to a retirement benefit, such benefits can be suspended, limited, or even eliminated for a variety of reasons, such as the windfall elimination provision (WEP), the Government Pension Offset (GPO) and even incarceration for more than 30 days!

How are Social Security Retirement Benefits Calculated?

A client's Social Security benefits are a function of the following three primary factors:

1. How many years they worked
2. How much they earned in each of those years
3. When they decide to claim benefits

Factor 1 – How Many Years Has the Client Worked?

When calculating a client's Social Security benefit, the Social Security Administration (SSA) uses 35 years of earnings history. If a client has worked for longer than 35 years, then only their highest 35 years of earnings – mostly adjusted for inflation – will be used in the calculation. Conversely, if a client has only worked for 28 years, Social Security will still use 35 years of earnings history to calculate the client's retirement benefit. That, of course, means that for such a client, seven out of 35 years – or 20% of the applicable years used by the SSA to calculate their retirement benefit – will be zeroes.

Although this rule applies with equal force under the law to both men and women, for the demographic currently grappling with claiming decisions, this rule tends to impact far more women than men. That's because many women took significant time away from work to raise one or more of their children. In fact, there are many times when, simply by looking at a client's Social Security statement, you can tell when they had children; instead of consistent earnings, the report is dotted with zeroes or very small earnings every two or three years. Today, the disparity of men to women is shrinking in this regard, but years ago, it was almost unheard of for a man to leave work for extended periods to assist in the childrearing process.

Factor 2 – How Much Has a Client Earned In Each Year?

It's no surprise that, in general, a history of higher earnings will produce a higher Social Security benefit, but that's not always the case. Earnings only help boost future Social Security benefits up to a certain point. In 2016 for instance, the maximum amount of earnings that is subject to Social Security taxes is $118,500. So, for example, if your client earns $118,500 this year, but their next door neighbor earns $118 million dollars, they will pay exactly the same amount of Social Security tax. And if that continued to be the case for 35 years, these two individuals would be entitled to exactly the same Social Security retirement benefit – assuming, of course, they claimed their benefits at the same age.

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When a client reaches age 62, the SSA will review all of a client's previous years of earnings and will apply an indexing factor – essentially a cost-of-living adjustment – in order to account for inflation to each of those years. If a client continues to work beyond 62, earnings in those years will be counted but only at their nominal, non-inflation-adjusted amounts. A client's highest 35 years of inflation-adjusted earnings are ultimately averaged and divided by 12 to get to what's referred to as the *average indexed monthly earnings* or AIME for short. The highest possible AIME in 2016 is $9,431.

Once the AIME is calculated, certain bend points are applied to determine a client's ultimate primary insurance amount (PIA), which is the amount of which they are entitled at their full retirement age (FRA). The bend points, in essence, make the first dollars paid in to Social Security more valuable than the last dollars paid in. On the first portion of a client's AIME, they "get back" 90 cents on the dollar; on the next portion it's 32 cents on the dollar; and on the final portion, it's 15 cents on the dollar. The applicable bend points are $856 and $5,157 in 2016. Here's how those bend points would impact someone with a maximum AIME:

- The first $856 of AIME – the amount up to the first bend point – is multiplied by 90% for a total of $770.40.
- The next $4,301 – the portion of the AIME between the two bend points – is multiplied by 32% for a total of $1,376.32.
- The remaining $4,274 of the client's AIME – the amount above the second bend point – is multiplied by 15% for a total of $641.10.

Those totals are then added together to produce a total, maximum PIA of $2,787.82 for 2016.

Note that due to the use of bend points in the calculation of Social Security income, paying twice as much into the system year after year does not result in a Social Security benefit twice as large. Instead, Social Security is built to replace a greater percentage of a lower-earning worker's income in retirement.

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Factor 3 – When Does Your Client Claim Benefits?

A client's PIA is a starting point of sorts. It tells you what they would get if they began receiving benefits at FRA – 66 for clients born between 1943 and 1954 – but the truth of the matter is that a relatively small percentage of the overall population chooses to begin receiving their benefit at that time. Most opt to claim their benefit sooner, and some choose to claim their benefit later. Each of these choices can have a marked impact on the amount of income actually received from the Social Security Administration during their lifetime.

Clients may choose to claim their Social Security retirement benefit as early as 62, but if they do so, their benefit will be reduced for life. The reduction is equal to 5/9 of 1% per month (6.67% per year) for the first 36 months claimed prior to FRA and 5/12 of 1% (5% per year) for each additional month.

In similar fashion, clients that wait to receive Social Security benefits (or suspend benefits already claimed) beyond their FRA receive a bonus for delaying those benefits, known as delayed credits. For each month a client delays receiving their own retirement benefit beyond their FRA, their benefit will increase by 8/12 of 1%, or at a rate of 8% per year. The following chart summarizes the percentage of the PIA a client reaching full retirement age at 66 will receive by claiming their own benefit at various ages.

Age	% of PIA
62	75.00%
63	80.00%
64	86.67%
65	93.33%
66	100.00%
67	108.00%
68	116.00%
69	124.00%
70	132.00%

An Overview of Spousal Benefits

Ask most married couples and they'll tell you, "Being married is hard work." Thankfully for some, there's a reward from Social Security in retirement for all of that hard work. It's called a "spousal benefit." A spousal benefit is a benefit paid to one spouse based upon the earnings record of the other spouse. To receive a spousal benefit, the following conditions must generally be met:

- A client must be married for at least one year.
- The client must be at least 62.
- The spouse on whose earnings record the spousal benefit is being calculated must have filed for their own benefit.

How are Spousal Benefits Calculated?

The amount of spousal benefits a client will receive is generally determined by two factors: when they claim benefits and the PIA of the spouse on whose earnings record the benefit is being calculated. Typically, a spouse is eligible to receive one-half of their spouse's PIA when the spousal-benefit-collecting spouse reaches full retirement age. Thus, the maximum spousal benefit for a client reaching FRA in 2016 is nearly $1,400.

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Example: Harry and Sally are married and each is turning age 66 in October this year. Harry has 35 years of solid earnings and is entitled to a benefit of $2,000 per month upon reaching FRA, but Sally has never worked. Once Harry begins collecting benefits, Sally can begin collecting half of Harry's $2,000 per month age-66 benefit, or $1,000 per month.

Similar to a client's own Social Security benefit, a spousal benefit may be claimed prior to FRA and as early as 62, but such amounts will be reduced. The reduction, which is applied to the worker's PIA prior to applying the 50% spousal benefit, is equal to 25/36 of 1% per month (8.33% per year) for the first 36 months claimed prior to FRA and 5/12 of 1% (5% per year) for each additional month. The following chart summarizes the percentage of a spouse's PIA a spousal-benefit-claiming client reaching full retirement age at 66 will receive by claiming their spousal benefit at various ages.

Age	% of Worker's PIA
62	35%
63	37.50%
64	41.67%
65	45.84%
66	50.00%

It's important to note that, unlike a client's own retirement benefit, spousal benefits offer no delayed credits. Thus, once a client reaches age 66 there is generally no reason to wait any further before claiming an available spousal benefit.

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Also worth noting is that divorced spouses may be able to claim spousal benefits as well. In order to claim such benefits, the following must apply:

- The marriage must have lasted 10 years or longer.
- The receiving spouse must not be remarried.
- The ex-spouse must be at least age 62.
- If the marriage ended more than two years ago, the ex-spouse does not need to have filed for their own benefit yet. If, however, divorce is within that window, such filing would be necessary.

Finally, advisors should be aware that the retirement and spousal benefits discussed above represent only a portion of the potential benefits Social Security may provide during a client's lifetime. Other key benefits include widow(er)'s benefits and child benefits for young and/or disabled children of claiming workers.