PRODUCT & ADVANCED STRATEGIES

Social Security Highlights & Strategies

What do most clients love about Social Security? A few popular answers include "Reliable income that pays until I die." "It might go up, but it won't go down." and "The federal government backs it." And while Social Security continues to be one of the most popular government programs, it is not without its limitations. The lack of a death benefit, a complicated set of filing options, and, in some cases, an irrevocable decision process means that clients need to take extra care electing when and how to take Social Security benefits.

THE LIMITS OF SOCIAL SECURITY'S INCOME

Take a look at your Social Security statement and it has traditionally stated:

> ***"...Social Security benefits are not intended to be your only source of income when you retire. On average, Social Security will replace about 40% of your annual pre-retirement earnings..."***

That leaves the financial professional in a critical position to help clients create strategies to provide at least 60% of their pre-retirement income from a source other than Social Security that starts when they retire. Additionally, for upper-income clients, they will find that Social Security will replace an even lower percentage of their pre-retirement earnings. This is because there is a maximum monthly Social Security benefit.

As a result, most advanced strategy Social Security discussions revolve around looking for strategies to optimize the level of benefits that can be provided by Social Security. Yet, even after implementing strategies, financial professionals will find that they will need to either generate significant retirement income outside of Social Security or find ways to "bridge the income gap" while clients wait for their Social Security benefits to kick-in. At the same time, care must be made to provide survivor benefits to protect against a premature death that may create chaos in a Social Security filing strategy.

RETIREMENT BENEFIT BASICS

Keeping in mind that most Social Security rules have exceptions, let's start with the basics.

To receive a Social Security benefit, a client must be "fully insured" with at least 10 years or 40 credits of work. One credit is recorded for every $1,510 (2022) in annual earnings, up to 4 credits per year.[1] The actual benefit amount is based upon the Primary Insurance Amount or PIA, which tracks actual earnings and indexes those earnings for inflation. The highest 35 years of indexed earnings are used to calculate benefits. As a client approaches retirement, they can replace lower-income years within those 35 years with higher income years, which can increase their Social Security retirement benefit.

Although full retirement age (FRA) varies by year of birth, benefits can start at age 62 or be delayed to age 70. The PIA is reduced if taken before a person's FRA and is increased if taken later than the FRA. Therefore, if filing can be pushed back beyond the FRA, the client receives higher Social Security retirement benefits. Every year of delayed filing up to age

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DETERMINING YOUR FULL RETIREMENT AGE[2]

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 alter	67

DETERMINING YOUR BENEFIT REDUCTION FOR EARLY RETIREMENT (AGE 62)[2]

Year of Birth	Full Retirement Age
1943-1954	25.00%
1955	25.83%
1956	26.67%
1957	27.50%
1958	28.33%
1959	29.17%
1960 and alter	30.00%

Hypothetical Case Study*: Mr. Client is single, age 60. His expected Social Security retirement benefit at his Full Retirement Age (FRA) of 67 is $3,000 per month. If he waits until age 70 to file and lives to age 90, his benefits will total over $1.3 million, assuming a 2% average cost of living adjustment. If he files at his FRA of 67, his total benefits drop by over $128,000. And if he files at age 62, he will lose over $344,000 by age 90.

SPOUSAL BENEFITS

For married couples, spousal benefits create opportunities for increased household benefits. The general rule on spousal benefits is that the spouse with the lower benefit amount can choose to receive the greater of his/her own benefit OR 50% of the other's FRA benefit as his/her spousal benefit. To receive spousal benefits, the other spouse must first file for his/her benefit. Like your personal Social Security benefit, spousal benefits will be reduced for filing before the recipient's FRA.

However, there is a significant opportunity for those born on or before January 1, 1954. These clients can file a "restricted" Social Security application for spousal benefits ONLY if their spouse has filed for his/her own retirement benefits. The electing spouse can then receive 50% of the other's FRA amount while allowing his/her retirement benefit to continue growing to age 70. To file restricted, the client must also be at least his/her full retirement age. Finally, only one spouse can file restricted, even if both meet the date-of-birth requirement.

DIVORCED SPOUSES

Spousal benefits get even more complicated in divorce. An ex-spouse can receive Social Security spousal benefits if:

- The marriage lasted at least 10 years.
- The receiving spouse is unmarried.
- Their work record is less than the ex-spouse.
- They are at least age 62.

An essential differentiation for divorced spouses is that they do not have to wait for their ex-spouse to file for their own benefits to receive spousal benefits. This prevents one spouse from delaying his/her Social Security benefits to prevent the other from receiving spousal benefits.

Ex-spouses also qualify for restricted filing if born on or before January 1, 1954. In fact, contrary to married couples, if both were born on or before January 1, 1954, they could both file restricted and begin receiving spousal benefits if the listed requirements are satisfied (i.e., not remarried, etc.). This becomes a filing strategy for potentially increasing benefits for divorced ex-spouses who have not remarried.

Just to make it a little more interesting, one ex-spouse's spousal benefit does not affect any other ex-spouse's benefit. In other words, for those who have been married and divorced numerous times, a number of ex-spouses may be receiving spousal benefits from the same former spouse.

SURVIVOR BENEFITS

Surviving spouses can receive a survivor's benefit if married at least nine months before death. The survivor gets the higher of 100% of the decedent's retirement benefit amount or his/her own benefit. Surviving spouses can begin receiving reduced survivor benefits at age 60 or age 50, if disabled. If the death was an accident or while on duty in the US military, then the 9-month requirement is waived.

Ex-spouses can also receive survivor benefits of up to 100% of a deceased ex-spouse's retirement benefit if married for 10 years to the decedent, at least 60 years old or age 50 if disabled, and, if remarried, did not remarry before age 60.

Finally, Social Security pays the surviving spouse a death benefit of only $255.

WORKING WHILE RECEIVING BENEFITS

Working before FRA can reduce Social Security retirement benefits in two ways. For those receiving benefits in the years before their FRA, Social Security is reduced for early filing AND reduced $1 for every $2 that client earns above $19,560 (2022).[3] In the year of FRA, the benefit is reduced by $1 for every $3 earned over $51,960 (2022) up to their birth month.[4] Once they reach their FRA, there is no reduction for earnings.

<u>Hypothetical Case Study*</u>: *Ann is 63 and is considering filing for Social Security retirement benefits to supplement her $50,000 annual salary. Her Social Security annual benefit at age 63 would be $24,000. However, her salary exceeds the 2022 income limit of $19,560 by $30,440 ($50,000 minus $19,560). Thus, her annual Social Security benefits would be reduced by half of the excess earnings, or $15,220. Her $24,000 of benefits would be reduced to only $8,780 ($24,000-$15,220).*

For those whose Social Security benefits are reduced due to working before their FRA, any reduction will result in a positive adjustment to the monthly benefit once they reach their FRA. Of course, any reduction for early filing will NOT be made up.

WITHDRAWING AN APPLICATION

Some clients start receiving Social Security benefits and then change their minds. Maybe a job opportunity appears, or they are simply not ready to retire, but they already filed. They have the option of paying back all amounts received and withdrawing their application within 12 months of the first month they collected benefits. They also have to pay back Medicare premiums taken out of their Social Security checks. This withdrawal is allowed only once per lifetime.

SUSPENDING BENEFITS

For those who change their mind but cannot pay back the money received, suspending benefits may be a solution. Once a client has passed the 12 months for withdrawing an application, they still have one option for increasing future benefits. They can suspend benefits at any time before age 70 and begin earning delayed credits. They can then restart benefits again at a later age and a higher level. Naturally, the delayed credits are not retroactive to the benefits already received.

It should be noted that due to changes in regulations, the strategy commonly referred to as "file and suspend" is no longer available.

TAXATION OF SOCIAL SECURITY BENEFITS

Determining whether your client's Social Security retirement benefits will be subject to federal income tax requires calculating what the Internal Revenue Service refers to as "provisional income." The calculation of provisional income is as follows:

Adjusted gross income + non-taxable interest + 50% of Social Security benefits

The percentage of Social Security benefits subject to income tax depends upon filing status and provisional income. It should be noted that unlike the Earnings Limit, the tax thresholds are not indexed for inflation.

Single/Head of Household	Over $25,000 base income	Up to 50% will be taxable
Married Filing Jointly	Over $32,000 base income	Up to 50% will be taxable
Single/Head of Household	Over $34,000 base income	Up to 85% will be taxable
Married Filing Jointly	Over $44,000 base income	Up to 85% will be taxable

Note that several states tax Social Security income as well.

TAX DIVERSIFICATION IN RETIREMENT

When working with upper-income clients, it can be generally assumed that up to 85% of their Social Security benefits will be subject to income tax. For example, a client with taxable income just below a higher income tax bracket may be pushed into that higher bracket when Social Security benefits are received. This has been referred to as a "tax torpedo", as it tends to sink otherwise well-planned retirement strategies.

The importance of designing a retirement income strategy that relies on taxable and non-taxable income cannot be overstated. Earned income, Social Security, interest, qualified plan distributions, and most other income will be taxable. But income from Roth IRAs and loans accessing cash value from a life insurance policy† should not increase your client's tax burden. And only the gain inside of a non-qualified annuity is taxable. However, it should be noted that while interest from municipal bonds may not be subject to income tax, it will count towards the provisional income calculation when determining whether Social Security benefits will be taxable.

Hypothetical Case Study*: *Jack and Jill, ages 67 and 60, are married and file a joint federal income tax return. Jack has reached his Social Security FRA and is now considering filing for his current annual Social Security benefit of $24,000 to supplement their lifestyle. The couple's expected taxable income in the year 2022 is $80,000, which places them at the top end of the 12% federal tax bracket. Although filing at his FRA will not reduce his Social Security benefits for excess earnings, the expected $24,000 of Social Security income will increase their joint federal tax bracket to 22%. That 22% tax rate will apply to most of the Social Security benefits.*

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To maintain the lower tax bracket for 2022 **and** *increase the couple's Social Security income, their financial professional reminds them that they have access to significant cash value inside their life insurance policy. The policy was previously placed to provide a death benefit as well as create some tax diversification for the couple. As a combined potential Social Security optimization and tax diversification strategy, the tax advisor now suggests withdrawing $24,000 of tax-free cash value from the life insurance policy in 2022 and delaying their Social Security filing for at least one year. Although the cash withdrawal may reduce the policy's death benefit, there is plenty of death benefit left for heirs. This strategy keeps the couple in the 12% tax bracket for 2022 and increases Jack's eventual Social Security benefit amount by waiting past his FRA.*

The combined strategies:

- Maintain their 12% tax bracket.
- Save Jack and Jill from paying 22% tax on $24,000 of Social Security income ($5,280).
- Increase the eventual Social Security income by approximately $1,920 (8% approximate annual increase due to waiting one year to file).
- Still allow the couple's income to increase by the desired $24,000 in 2022 (tax-free cash value withdrawal).

As the hypothetical case study illustrates, retirement income planning must begin well in advance of that retirement. A common strategy is to use taxable earned income and qualified plan distributions in concert with Social Security benefits to stay just below a higher tax bracket. Access to non-taxable Roth IRAs and life insurance's cash value can keep a client in that lower tax bracket while maintaining the client's desired lifestyle.

*These are hypothetical examples for illustrative purposes only.

†Policy loans and withdrawals will reduce available cash values and death benefits, and may cause the policy to lapse or affect any guarantees against lapse. Additional premium payments may be required to keep the policy in force. In the event of a lapse, outstanding policy loans in excess of unrecovered cost basis will be subject ordinary income tax. Withdrawals are generally income tax-free, unless the withdrawal amount exceeds the amount of premium paid. Tax laws are subject to change. Encourage your clients to consult their tax professional.

(1) Social Security Administration Publication No. 05-10072: How You Earn Credits, January 2022
(2) https://www.ssa.gov/benefits/retirement/planner/agereduction.html
(3) https://www.ssa.gov/benefits/retirement/planner/whileworking.html
(4) See note 3.

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