

Social Security – the Ins and Outs of Retirement Benefits

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Social Security reaches almost every family, and at some point will touch the lives of nearly all Americans. Today, about 164 million people work and pay Social Security taxes and about 50 million people receive monthly Social Security benefits. Most beneficiaries are retirees and their families – about 34 million people (source: Social Security website, www.ssa.gov).

This paper will provide information on how the system works, when benefits can be taken, things to think about when electing to receive benefits and the potential taxability of benefits.

Why Is This Information Important?

The first of the 79 million baby boomers turned 62 in 2008. Since that time, approximately 10,000 individuals have become eligible for Social Security retirement benefits each day, and this trend is expected to continue through 2028 (source: Social Security website, www.ssa.gov). The decision on when to begin receiving Social Security benefits is an important one, and one that people may need help making.

How the System is Funded

The Social Security retirement system is currently funded through a payroll tax. It is commonly known as FICA – the Federal Insurance Contributions Act – and is divided into two parts: Social Security and Medicare. In the past, employees and employers have each paid 6.2% for Social Security (OASDI) taxes up to the maximum wage base and 1.45% for Medicare on all earnings. With the passage of the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010, employees will see their share of the Social Security tax reduced by 2 percentage points, to 4.2% for 2011. Employers will continue to pay 6.2%. The maximum taxable wage base is \$106,800 – the same as it was in 2010 (and 2009). There is no earnings limit for Medicare.

When Retirement Benefits Can Begin

There are three main points in time that individuals think of when it comes to receiving Social Security retirement benefits:

- Early Retirement
- Full Retirement Age
- Delayed Retirement

Before an individual commences benefits, he/she must be fully insured. Fully insured means an individual has earned the required number of Social Security credits. Most workers need 40 credits, or about 10 years of work.

Early Retirement

Fully insured individuals can begin receiving benefits at age 62. The benefits will be less than what would have been payable at Full Retirement Age (FRA). The reduction is anywhere from 20% to 30%. The reduction is permanent. That is, benefits do not increase to the full amount at FRA.

Full Retirement Age

An individual's FRA is based on the year in which he/she was born. The table below shows how to determine FRA.

| Year Born | Full Retirement Age |
|--|----------------------------|
| 1937 or earlier • add 2 months to each year after 1937 until 1943 | 65 |
| 1943 – 1954 • add 2 months to each year after 1954 until 1960 | 66 |
| 1960 and later | 67 |

Delayed Retirement

Benefits can be increased if an individual chooses not to receive them at FRA. By opting to wait, an individual will earn delayed retirement credits for each year beyond FRA, up to age 70. The table below shows the increases, which are based on an individual's year of birth.

| Year Born | Delayed Retirement Credit |
|------------------|----------------------------------|
| 1939 – 1940 | 7.0% |
| 1941 – 1942 | 7.5% |
| 1943 and later | 8.0% |

Factors to Consider

In making the decision, individuals must consider several factors.

- Other family members who will qualify for benefits based on their record
- Other sources of retirement income
- Current health condition
- Whether they plan to continue working while receiving benefits

Family Benefits

Spouses and children may also receive Social Security benefits based on an individual's earnings record. The spouse benefit is 50% of the worker's Primary Insurance Amount (PIA) if the spouse has reached FRA. A spouse can receive benefits as early as age 62. However, the benefit will be reduced; it will be between 32½% and 35% of the worker's PIA.

In many cases, an individual's spouse is also insured for a retirement benefit. In this case, the spouse's own benefit is paid first. If the spouse benefit is higher than the individual's own retirement benefit, he/she will receive a combination of benefits equaling the higher spouse's benefit.

An eligible child's benefit is equal to 50% of the worker's PIA. Eligible children are those that are unmarried and any one of the following:

- Under age 18;
- Up to age 19, if in high school; or
- Any age, if disabled before age 22.

Other Sources of Retirement Income

In addition to Social Security, an individual's retirement income can come from other sources, like employer plans (e.g., 401(k), pension) and personal savings. These need to be considered when choosing to start receiving Social Security benefits.

Current Health Condition

People who are in good health might consider delaying in order to receive a larger benefit. Individuals who have health issues may opt to take benefits earlier.

Working While Receiving Benefits

Many people choose to work while they receive Social Security benefits. If an individual is under FRA, there are limits on how much he/she can earn from working, without impacting the benefits. If earnings exceed the limits, benefits will be reduced. In 2010 and 2011, the limits are as follows:

- If an individual is under FRA, he/she can earn \$14,160 without a benefit reduction. If he/she earns more than this amount, \$1 of Social Security benefits is withheld for every \$2 earned above that limit.
- In the year an individual attains FRA, there is a separate limit of \$37,680 for the months before attaining FRA. If he/she earns more than this amount, \$1 in benefits is withheld for every \$3 earned above the limit.
- Beginning with the month an individual reaches FRA, there is no limit on earnings.

Survivor Benefits

In addition to retirement benefits, Social Security provides benefits for widows/ widowers, as well as children. In general, a spouse can receive survivor benefits beginning at age 60. Like retirement benefits, the amount will be reduced if the spouse is under FRA.

Taxation of Social Security Benefits

Benefits are income tax-free for some individuals. Those with income within certain thresholds may pay federal income tax on 50%, or up to 85%, of their Social Security benefits.

When determining if Social Security benefits are taxable, an individual must first calculate his/her modified Adjusted Gross Income (mAGI). This includes things like earnings, pensions, IRA distributions, dividends and taxable interest, as well as certain items that are normally tax-exempt, such as tax-exempt interest. One-half of the individual's Social Security benefits are then added to mAGI. This total amount is then compared to the following thresholds:

Single or Head of Household:

- Less than \$25,000 – benefits are tax-free
- \$25,000 – \$34,000 – up to 50% taxable
- Above \$34,000 – up to 85% taxable

Married Filing Jointly:

- Less than \$32,000 – benefits are tax-free
- \$32,000 – \$44,000 – up to 50% taxable
- Above \$44,000 – up to 85% taxable

Benefit Maximization Strategies

As noted throughout this paper, the decision of when to begin taking Social Security benefits is a complex one. The following section discusses three strategies clients can consider in an effort to maximize the amount of benefits they receive.

1. Changing Your Mind

Many people think that once they elect to receive Social Security benefits, the decision is irrevocable. There is actually a way to suspend benefits and restart at a later date. Formally called a Request for Withdrawal of Application, it gives an individual who may regret taking a reduced benefit a chance to reset the benefit at a higher amount in the future. Future benefits are suspended once the Social Security Administration approves the request. An individual must apply for such a withdrawal within 12 months of the first month he/she was entitled to receive benefits.

Keep in mind that individuals are entitled to one withdrawal per lifetime. And individuals may voluntarily suspend benefits only for the months beginning after the month in which the request is made. This is a change from how this feature worked in the past. Individuals had been able to apply for a Request for Withdrawal of Application at any time, and were able to suspend past, present and future benefits. The new process was implemented in December 2010.

2. File and Suspend

While some spouses retire at the same time, many do not. The decision on when to begin taking Social Security benefits is a bit more complicated. Thanks to the File and Suspend provision, married couples who retire at different ages can really maximize their benefits.

Assume Michael has reached his FRA of 66. He wants to continue working until age 70 to get his delayed retirement credits. Also assume his wife, Susan, is age 62 and just retired. She is fully insured and could receive a benefit based on her own earnings. However, she was in and out of the workforce over the years, resulting in a spouse benefit that is higher than her own benefit. Michael can file for Social Security benefits, but requests an immediate suspension of benefits. This allows Susan to apply for a spousal benefit at Michael's benefit level. Michael will not receive any benefits until he reapplies, presumably at age 70. At that time, Susan would receive a higher benefit, based on what Michael would have received at FRA. In addition, Susan's survivor benefit would also increase.

3. The Restricted Application

In the example of Michael and Susan, what if Susan's own benefit was higher than her spouse benefit? She may not want to draw on Michael's record. Instead, she could draw on her own record. How does this benefit Michael? He can do what is called "restricting an application" and file as a spouse on Susan's record. As mentioned above, Michael is at FRA so he would receive the full spouse benefit – one-half of Susan's benefit. At the same time, he would continue to earn delayed retirement credits on his own record. When Michael reaches age 70, he could refile for benefits on his own record. This would also result in a higher survivor benefit for Susan.

Conclusion

The decision of when to begin taking Social Security benefits is a complicated one. Many factors need to be considered, and careful analysis must be done. Each person's circumstances are different and must be looked at individually in order to maximize the benefits from this important source of retirement income.

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