Strategies for Maximizing Social Security Benefits

We are asked from time to time to help our clients decide when to take their Social Security benefit. There are some strategies to consider in making this decision. However, unless you live much longer or die much younger than expected, the economic difference between strategies is small.

Context

As with any financial decision, the first step is to put it into context. Most discussions of collecting Social Security focus on whether to begin at age 62 or wait until normal retirement age (NRA). This discussion generally focuses on the present value of the expected benefit assuming various mortality ages. A present value is a lump-sum equivalent value at a particular point in time and is calculated by applying a "discount rate" to the payments.

For example, a Social Security participant who is age 62 might estimate the present value of the Security Benefit from age 62 to age 82 at $321,000. And then compare that with an estimate of $331,000 for the present value of the benefit from NRA through age 82. Based on these present value estimates, the decision to wait until NRA would have a present value advantage of about $10,000.

Reviewing the above analysis might lead one to conclude that waiting until NRA is the best choice. It is true that waiting until NRA produces the highest before-tax present value of benefit if you use a discount rate based on long-term U.S. Treasury Bonds and the primary insured lives to the normal mortality age. However, health issues, family longevity, investment portfolio characteristics and tax considerations can impact the present value calculation.

Impact of Dying Young

Let's say both the insured dies at age 78. The present values of the benefits through age 78 are $267,000 for benefit beginning at age 62 and $259,000 for benefit beginning at NRA. Therefore, waiting to begin collecting Social Security until NRA, would have resulted in a present value of benefits collected of $8,000 less than initiating benefits at age 62. What is the impact of suffering that disadvantage? Assuming spending was reasonable, the impact is a slightly smaller estate.

Impact of Living Long

Now let's say the insured lives to age 95. The present value of the benefit beginning at age 62 is about $470,000 and the present value of the benefit beginning at NRA is about $531,000, yielding a $61,000 present value advantage of waiting.

Living to age 95 may not be very likely, but living beyond age 90 is happening with greater and greater frequency and it is a situation that could challenge even a sensible financial plan. So the key question is, is it worse to die young and fail to maximize the present value of their Social Security benefit for the benefit of their children, or whether they want to focus on the risk that they live a long time and fail to maximize the present value of their Social Security benefit for themselves?

Even from the children's perspective, it may be better to focus on maximizing the benefit for the primary insureds. If they die young, the children receive an inheritance and do not have to consider the risk that they may be responsible for supporting their parents. However, if the primary insureds live a long time and spend all their wealth, the greatest gift they may be able to leave their children is their own financial security.

The impact of this discussion can also be viewed from a monthly benefit perspective. The monthly benefit at age 90 if payment started at age 62 would be $3,288 versus $4,415 if the start of payments was delayed until NRA. This difference of $1,127 per month is only $564 in today's dollars, but that could still be very significant to a 90 year old who is running out of money.

The Best Choice Depends on Priorities

This information has been presented in a way that advocates waiting to collect Social Security benefits, but that is not really the message. The message is that either collecting early or late could make sense depending on circumstances. If the only alternative source of income is a retirement plan, the tax cost of waiting is higher, a case can be made that beginning early is likely to be a better economic choice. However, if the spouse is younger or if the focus of the decision is minimizing the likelihood of facing economic stress in the future, then the case can be made that waiting is a better choice. Neither is right or wrong, they just depend on circumstances and objectives.

Other Strategies and Considerations

You must also consider your alternative sources of income. If you have a substantial personal portfolio from which to draw, then the cost of waiting until NRA is lower than if you must withdraw funds from a retirement plan.

Waiting beyond NRA until age 70 can also be an appropriate strategy. However, the present value of the benefit of waiting until age 70 is less than the present value of the benefit of waiting until NRA.

Coordination with the spousal benefit can also present some planning opportunities. Firstly, the spouse cannot collect a spousal benefit until the insured begins the primary benefit. This means that the cost of waiting is increased. However, this cost can be reduced if the spouse qualifies for a benefit based on his or her own earnings record. If the primary insured waits until the NRA and the spouse reaches age 62 before that time, it can make sense for the spouse to begin his or her own benefit at age 62 and then switch to the spousal benefit if it is higher when the primary insured begins his benefit. However, a cautionary note when considering this strategy is that the spousal benefit is reduced for collecting before NRA regardless of whether the spouse collects his or her own benefit or a spousal benefit.

The discount rate used in these present value calculations can have a significant impact. Generally, a discount rate is selected to match the rate on intermediate to long-term Treasuries since both Social Security and Treasuries are fixed long-term federal government obligations. However, the actual economic impact will result from the actual use of funds. If beginning Social Security early means withdrawing less from an investment portfolio, then the true impact will result from the actual return earned. If the portfolio includes equities, the discount rate could be based on this higher return and the break-even age will be older. This means that the insured or his spouse must live longer to benefit by waiting to collect their benefit.

This produces a theoretical conundrum since the apparent conclusion that starting the benefit earlier is better is partially due to taking more risk. This is why the normal way to analyze these benefits is using a lower discount rate based on fixed income interest rates. It is theoretically possible to adjust the asset allocation based on the present value difference in the alternatives. However, this is rarely done in a precise way. It is nonetheless important to consider the reality of how this will play out in the real world.

All of these discussions are based on the premise that the Social Security system will be able to meet its obligations. However, the existing system is not expected to be sustainable. The economics of waiting may be different if future payments are reduced. Regardless of the economics, some people argue that you should take what you can get from Social Security while you can get it.

In summary, there is no definitive answer to the question of when to begin taking Social Security benefits. If you would like to discuss the way in which these issues impact your personal Social Security benefit, contact us and we will be happy to help.