THE TRUTH ABOUT WHEN TO BEGIN TAKING SOCIAL SECURITY

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With so many Americans reaching the early retirement age of 62, the question of *to begin* taking Social Security benefits has never been more on the mind of "sixty-somethings." Many "online calculators" exist that attempt to give simple answers to this pressing question but the truth is there are so many factors to consider that solely relying on an online calculator to provide a meaningful answer may not be realistic.

It's has been stated in mass media that you can get a return of 6% to 8% for every year you delay beginning to take Social Security benefits up to age 70. While that's roughly correct (the increase from year to year varies between about 6% and 8%) it's short-sighted because it ignores so many other potentially equally-important factors. We'll address those factors here.

<u>Factors to Consider In Determining When to Begin Taking Social Security Benefits</u>

We'll address each of these factors separately below, but wanted to list them for you here so that you are able to quickly jump to any section that is of interest to you.

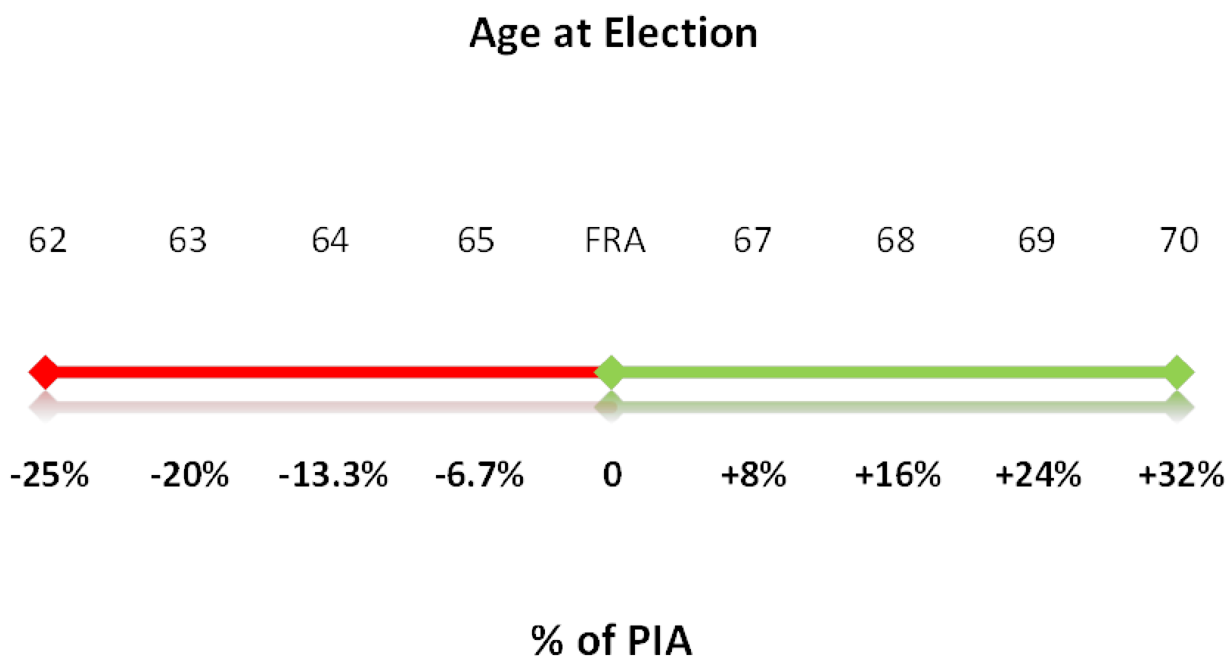
1. The Social Security Surrender Penalty.
2. Do you currently need the income from Social Security benefits?
3. How are taxes on Social Security benefits calculated?
4. Will you want or need to continue working after you begin to take Social Security benefits?
5. What impact will retirement account Required Minimum Distributions have on your taxable retirement income?
6. Longevity – What's your family history? What's your health history?

<u>Section One: The Social Security Surrender Penalty</u>

Let's look at a hypothetical example, let's say you purchased an annuity that had enough money in it to permit you to quit working and retire today. You call your insurance agent and ask him to cash it (surrender the policy) in for you today and the agent asks you if you're sure. "Yes I'm sure" you reply! Then the agent says something you hadn't considered, "I'd be glad to have the annuity cashed in and you'll have a check in your hands next week. But … to do this, you're going to be assessed a 25% penalty on the money in your annuity and, I'm sorry to tell you, you'll never get that money back. Before I send in the request … are you *sure* you want to do this?"

So ask yourself this: if your annuity was worth $1,000,000, would you be willing to forfeit $250,000 in order to get $750,000?

Let me show you a chart that tells you what percentage of your full retirement benefit you forfeit when you opt to start receiving Social Security benefits prior to your Full Retirement Age (FRA).



Did you realize than when you opt to begin receiving Social Security at age 62, you are surrendering 25% of your full Social Security retirement benefit (Primary Insurance Amount, aka PIA)? On what other financial account would you be willing to accept a 25% surrender charge? Since Social Security is one of the most powerful financial incomes you have, does it make sense to accept that kind of loss? And bear in mind, the power of Social Security goes beyond the mere benefit. It's a tax-favored income; it's guaranteed for life, indexed for inflation and cannot be reduced. *Are you sure* you want to take a 25% surrender charge?

If you're married, the issue can be more complex. Spousal benefits are even more reduced at age of election. Take for instance: Bob is 64 and Sally is 63. Sally would receive the better of her PIA at 80% or 35% of Bob's PIA benefit.

Spouse Age	62	63	64	65	66	67
Roughly the % of Primary Spouse PIA	32.5%	35%	37.5%	41.7%	45.8%	50%

To make it crystal clear, in the example above, Sally won't get "half of Bob's" Social Security as is normally assumed at age 67. She'll end up with 35% of Bob's PIA. It's a reduction of 65% percent How many *tax-favored, inflation indexed, guaranteed lifetime income accounts would you be willing to take a 65% surrender penalty on? Here is another way to look at the above situation. Let's say Bob's PIA benefit is $2,000 per month. If Sally waited until full retirement age she would receive 50% of Bob's benefit which is $1,000. If Sally elects to receive benefits at age 63 she would receive 35% of Bob's benefit which is $350. This is a 65% reduction in the rate of the benefits.*

If your financial professional hasn't discussed the Social Security surrender penalty with you yet, it's not a total surprise. The vast majority of "financial professionals" we have spoken to aren't up to speed with Social Security benefit planning strategies. Social Security planning is a specialty that many professionals have not been educated on.

<u>Section Two: Do you currently need the income from Social Security benefits?</u>

If you can't retire without taking Social Security benefits, then you need to decide if you're ready to retire or willing to keep working. If you can't retire without Social Security and you're determined to retire now in spite of the financial disincentives, then it's not so much a financial calculation as it is a lifestyle choice. If your decision to retire is made, and you can only do so by taking Social Security now and accepting the surrender penalty, that's fine. Only you can balance the emotional side of this important decision against the financial decision of the choice and decide if it's worth it. I think most people would just go ahead and retire and move on. I don't think most people are going to postpone retirement if it's something they really want to do simply because they might come out ahead 15-20 years in the future by virtue of waiting a couple of years.

Section Three: How are taxes on Social Security benefits calculated?

Whether your Social Security benefit is included in your income for tax purposes — and, if so, what percentage is included — is based on a formula known as Provisional Income. Provisional Income is the sum of all income including interest and dividends from savings and investments, long and short term capital gains, income from working, interest from tax-free municipal bonds, income from pensions and interest from annuity income plus 50% of your total Social Security benefits.

Here's an example:

	Single	Married
Income From Work	$6,000	$0
Municipal Bond Interest	$1,000	$6,000
Interest from savings	$1,000	$6,000
Pension Income	$6,000	$6,000
Annuity Interest Income	$0	$0
Capital Gains	$1,000	$0
50% of Social Security	$9,000	$18,000
Provisional Income	$24,000	$36,000

If you are unmarried and your Provisional Income is less than $25,000, as in the Single example above, none of your Social Security benefit is included in your income and is untaxed. If you're single and your provisional income is between $25,000 and $34,000 then 50% of your Social Security benefit is included in your income and taxed. If you're single and your provisional income is greater than $34,000 then 85% of your Social Security benefit is included in your income and taxed.

If you're married and your provisional income is less than $34,000 then none of your Social Security benefit is included in income and is untaxed. If you're married and your Provisional Income is between $34,000 and $44,000 then 50% of your Social Security benefit is included in your income and taxed. If you're married and your Provisional Income is greater than $44,000 then

85% of your Social Security is included in your income and taxed. Here's a chart that summarizes these calculations.

		Provisional Income	
Unmarried	<$25,000	$25,000 - $34,000	>$34,000
Married	<$34,000	$34,000 - $44,000	>$44,000
What percent of Social Security taxed?	None taxed	50% included in income	85% included in income

The decision-making process regarding when you will take benefits should include whether or not and how much of your Social Security will be taxed. If your Provisional Income is low and your Social Security won't be taxed, you might want to start taking benefits sooner rather than later.

Another factor in your decision is arranging your income in such a way as to minimize your Provisional Income. Several factors that are included in Provisional Income are under your control. Interest income from savings, interest from corporate and government bonds, interest and capital gains from investments, municipal bond interest and wages (income from working) are all factors that you can choose to change.

- Interest from savings and from corporate or government bonds: interest you earn on savings accounts such as certificates of deposit, savings accounts or money markets that is not earned inside of IRA/401k-type accounts is included in your provisional income whether you withdraw it to spend or leave it in the account to grow and compound. If you are not withdrawing interest earned on your savings or bonds, you can choose to reposition that principal into a tax-deferred account, continue to earn interest but *not* have that interest included in either your income or provisional income unless you take a withdrawal. For some people, making this change can be enough to reduce taxation of Social Security income.

- Many retired investors were brought up to believe that tax-free municipal bond interest is tax free but, in reality, the fact that it's included in the calculation of Provisional Income means it's not *entirely* tax-free. Similar to taxable interest from savings accounts, repositioning municipal bond assets into tax-deferred accounts removes that interest from the calculation of Provisional Income until you decide to withdraw it to spend and can cause taxation of Social Security to be lowered or even eliminated entirely.

- Wages: we'll discuss the effect that wages have on Social Security benefits in a separate section, but from a big picture perspective, every dollar you earn is included in Provisional Income. If you don't really need the income and choose to work less or stop working, you may be able to reduce Provisional Income and reduce or eliminate taxation of Social Security income.

- Dividends and capital gains from investments: as with the other items above, if you aren't spending the dividends or capital gains you're earning on investments and reposition those assets into tax deferred accounts, you have the ability to potentially cut the taxes that you pay on Social Security.

Bear in mind that there are items that you are not able to control that could, by themselves, be causing your Provisional Income to be greater than the highest bracket ($34,000 if single; $44,000 if married). For example, if your pension is $44,000, whether you're married or single, 85% of your Social Security income will be taxed. That means that *from a reduction of Provisional Income perspective*, there's no benefit to repositioning money into tax-deferred accounts. (That doesn't mean that it might not be worthwhile from an overall *income tax perspective*; it just means that whether you do or don't, it isn't going to change the percentage of Social Security that's included in your income for tax purposes.)

<u>Section Four: Will you want or need to continue working after you begin to take Social Security benefits?</u>

One of the most important considerations to account for is earned income before you reach "Full Retirement Age" (FRA) when you are receiving Social Security retirement benefits. Each of us has a "Full Retirement Age." Depending on when you were born, that age is gradually increasing to age 67. If you work after beginning to take Social Security benefits and before you reach your full retirement age, you may have to return part of your Social Security. You can find your FRA below.

Full Retirement Age

If you were born in 1946 or earlier, you are already eligible for your full Social Security benefit. If you were born from 1947 to 1960, the age at which full retirement benefits are payable increases gradually to age 67. The following chart lists the full retirement age by year of birth.

Age to receive full Social Security benefits	
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 later	67
Note: *People who were born on January 1 of any year should refer to the previous year*	

Source: Social Security Administration; www.ssa.gov

The amount of money you can earn is indexed by inflation in most years. Here's how Social Security summarizes the effect working and having earned income while receiving Social Security retirement income affects your Social Security benefits.

"You can get Social Security retirement or survivor's benefits and work at the same time. But, if you are younger than full retirement age and earn more than certain amounts, your benefits will be reduced. It is important to note, though, that these benefit reductions are not truly lost. Your benefit will be increased at your full retirement age to account for benefits withheld due to earlier earnings.

"If you are younger than full retirement age, there is a limit to how much you can earn and still receive full Social Security benefits. If you are younger than full retirement age during all of 2012, we must deduct $1 from your benefits for each $2 you earned above $14,640.

"If you reach full retirement age during 2012, we must deduct $1 from your benefits for each $3 you earn above $38,880 until the month you reach full retirement age." (Source: Social Security Administration; http://www.ssa.gov/pubs/10069.html)

The good news is that you won't really "lose" the benefits that you give back because you get them back in the future. The bad news is, until you reach full retirement age, working can cause you to give back some of your Social Security benefits.

It's important to note that earned income means just that; income that you earn from actively working. Earned income does *not* include interest, dividends or pensions. Those types of income *can* increase your Provisional Income enough to cause some of your Social Security to be taxed, but *cannot* cause you to have to "give back" benefits.

Section Five: What impact will IRA/401k and other retirement account Required Minimum Distributions have on your taxable retirement income?

One of the most overlooked planning areas is the consideration of what to do if you have significant retirement accounts (IRA/401k-type accounts) and know that the withdrawals the government will force you to take when you reach age 70 ½ may cause your Social Security to be taxed.

Many people might ask, "Well, what can I do about that? After all, I have to make those withdrawals, right?" Well, yes. If you do nothing now, then you will have to take those required withdrawals. One question is: what can you do now?

The answer comes back to a discussion of taxes. As of now, tax rates are at low levels compared to what they have been historically. What do *you* think will happen with tax rates in the coming years? Do you think it's possible that tax rates and tax brackets might change? If you think they might increase, then you may want to consider taking withdrawals from your IRA/401k-type accounts before you are forced to do so.

If this might help you, you might want to not simply withdraw from your IRA-type accounts but *convert* your traditional IRA accounts into ROTH IRA accounts. ROTH IRA's do *not* have required minimum distributions because you've already paid taxes when you converted from the IRA/401k to ROTH. Further, if you have other resources and income and don't need income from your IRA accounts, you could allow your ROTH accounts to grow and compound tax-free and potentially leave a larger legacy to your heirs which they can then withdraw from tax-free. While a spouse can inherit a ROTH IRA and *not* be forced to take minimum distributions, anyone else who inherits a ROTH IRA is required to take minimum withdrawals annually but they do not have to pay taxes on the withdrawals. The amount they are required to withdraw is typically fairly small and an inherited ROTH can potentially continue to grow for the benefit of your kids and even grandkids.

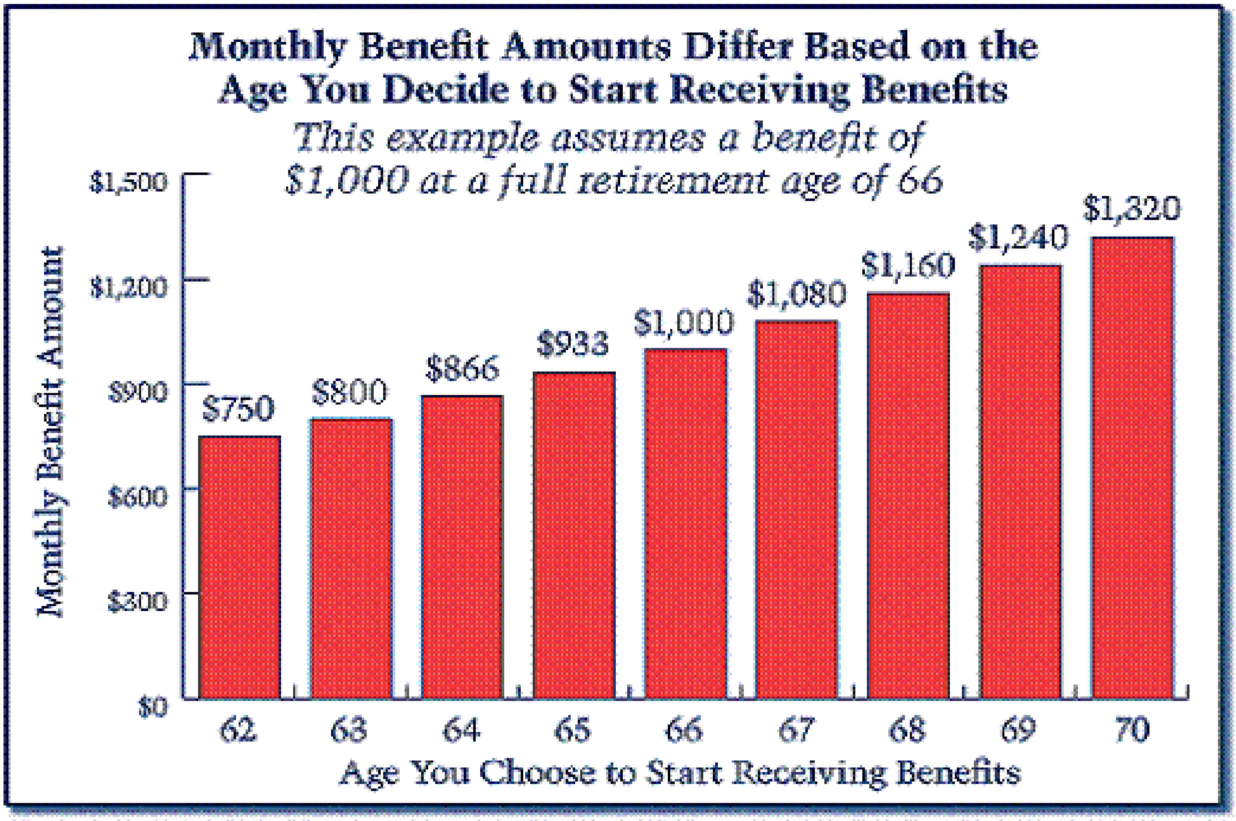
And remember – implementing this strategy could potentially reduce or eliminate the taxation of your Social Security for a long, long time. Saving taxes on Social Security is not like deferring taxes on interest. Every dollar you save or eliminate in tax on Social Security is money that *never* has to be repaid.

Section Six: Longevity

The single biggest and most difficult question to answer in determining when to take Social Security benefits is how long you're going to live. If we knew exactly how long you'd live, it would be infinitely easier to know when to start taking benefits. In general, the longer you will live, the more sense it could make to delay taking reduced early benefits in lieu of higher benefits that begin after delaying for a period of time.

People often ask what the "break-even" is in terms of number of years between taking benefits as soon as possible versus delaying. The answer is, "it depends" but for a general answer, let's look at a graphic from the Social Security Web site.

Summary



For someone who took early benefits at age 62, they would receive a monthly benefit of $750 or $9,000 per year. Over 18 years to age 80, they would be paid $162,000. Compare that to the person who waited to age 66 and receives $1,000 per month or $12,000 per year. Over the next 14 years to age 80, the person who delayed starting their benefits would be paid 168,000. That's pretty close to the same. So, it took roughly 18 years before the person who delayed caught up to the person who started right away.

Does that mean that you could conclude that it takes about 18 years to break even? Again, it depends. Keep in mind, the way things stand today.

So when should you start receiving Social Security benefits?

Your answer to this question will depend on your personal circumstances. In this equation, you should consider both your family's longevity as well as your own health. Let's look at a story Andy Atchinson Co-Founder of www.PlanMyBenfit.com shared with us. Larry the father of a coworker of Andy retired the month he turned 55 (not a typo; fifty-five). The reason Larry retired at age 55 was because he had properly planned for retirement and because his father died at the young age of 60 without having ever enjoyed retirement and he was afraid that he may die early, too. Larry is 77 today (2012) and has been retired for 22 years. So while you might consider your family heritage, your own health should be a big part in your decision. According to an article published on February 11, 2010 in TIME Magazine titled Health Check Up: How to Live 100 Years on had this to day "While genes are certainly an important component of aging, they may not be the most relevant factor, if only because we don't have much control over them. The good news is that according to animal studies, only about 30% of aging is genetically based, which means the majority of other variables are in our hands". In the case I referred to above, this man's father had serious heart issues. The man who retired at 55 had no heart issues and still doesn't. He's going strong and there's a very good likelihood he'll live another 10 years or more.

In thinking of your own health, there's something else to bear in mind: the rate of advances in medical treatment is gaining speed every year. Things that might have killed us ten or twenty years ago are now routinely resolved. Medicine now keeps us alive longer than ever before and chances are you'll live longer than you expect and possible longer than your parents.

According to a US Census Bureau report released November 17, 2011, and supported by the National Institute on Aging (Report CB11-194), "The nation's 90-and-older population nearly tripled over the past three decades, reaching 1.9 million in 2010. Over the next four decades, this population is projected to more than quadruple."

If you're not planning for the possibility that you may live into your 90's you may be ignoring reality.

After reading this, do you see why we started off by saying that we haven't run across an online calculator that takes enough of the factors into account to make it worthwhile? The reality is, no two families are the same even if they "look the same" on paper. One couple might want to leave a big inheritance; another might want to spend every penny while they're alive.

We would suggest that this is a complicated enough planning area that it makes sense and is worth your time to visit with a competent financial professional who is well versed in advising people and takes into account all of the factors relevant to your specific situation. The money you save in unnecessary taxes and in the achievement of your maximum wealth will make it well worth your time. It will also give you the peace of mind that will come from knowing that you didn't do it on your own and possibly overlook or miscalculate something critical.