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Understanding Social Security Benefit Estimates

By Elaine Floyd, CFP®

If you track your Social Security benefit estimates via your annual statement, you've probably noticed some variations. How can it be that the amount you are scheduled to receive at full retirement age (FRA) is different—perhaps even lower—than it was a few years ago?

EARNINGS ASSUMPTIONS

The reason is that the Social Security Administration (SSA) is basing your future benefit on certain assumptions. One key assumption relates to your earnings. Using a complex algorithm that factors in your past earnings as well as projections for your future earnings, SSA refigures your benefit estimate every year, sometimes changing the amount based on variations in the average wage index. In other words, if they've been assuming your wages would rise by X% but the average wage index rises by less than X%, they will adjust your benefit estimate to account for the lower increase. If you see your benefit estimate go down, it doesn't mean they are reducing your benefit; it means their prior estimate was too high.

ACTUAL EARNINGS

Another thing that can cause your benefit estimate to be off is that your actual earnings may turn out to be different from SSA's assumptions. In this case you may not find out until you apply for benefits that the amount you've been seeing on your statement is not the amount you will actually receive. SSA assumes you will keep working at the same salary (plus annual raises) until claiming age. The amount you are projected to receive if you apply at your FRA, called your primary insurance amount or PIA, assumes you will keep working until FRA. The amount you are projected to receive if you apply at age 70 assumes you will keep working until age 70. If you stop working prior to claiming age, your benefit could turn out to be lower than the amount you see on the statement.

WHAT IF YOU RETIRE EARLY?

How much will your benefit be if you retire at, say, age 55? If you are a maximum earner – that is, you earned the maximum amount on which Social Security taxes are paid each year for 35 years—you will still receive close to the maximum benefit. But because recent earnings count for more than earlier earnings, even after those earlier earnings are indexed for inflation, the fact that you had zero earnings for the 12 years leading up to your FRA will cause your benefit to be lower than the amount shown on your statement.

Using the SSA Quick Calculator, we see that the benefit for a maximum earner age 55 who keeps working to age 67 and who claims his benefit at FRA is $3,281. But if he stops working at 55, his age-67 benefit is $3,200, a difference of $81 per month. Needless to say, a lot goes into the decision to retire at 55. You must have enough income from other sources to get you by before Social Security starts, whether you take a permanently reduced benefit at 62 or hold out for the maximum benefit by claiming at 70. Before making any decisions, you will need to have accurate data. To see how your Social Security benefit may be affected by stopping work early, use the Retirement Estimator at your Social Security account: www.ssa.gov/myaccount.

WHAT IF YOU WORK LONGER?

The flip side of retiring early is working longer. More baby boomers are working well into their 60s and 70s today, even after they've started receiving Social Security benefits. How will continued work affect their Social Security benefit?

Here's an example for a maximum earner born in 1960. Upon turning 62 in 2022, his PIA is officially calculated based on his highest 35 years of indexed earnings. Having earned the maximum each year, his PIA is calculated to be $3,357. (Note: this is the amount he will receive in four years when he applies at his FRA, not the reduced amount he would receive at age 62.)

Now, what if he works another four years? Because recent earnings count for more than earlier earnings even after indexing, his PIA will go up. But not by very much. His new PIA, calculated with four years of additional earnings (and four years of earlier earnings dropped off his record to count exactly 35 years of earnings), would be $3,386, just $29 higher. These numbers do not account for annual cost-of-living adjustments.

As this illustration shows, once you already have 35 years of maximum earnings, additional earnings will not increase your Social Security benefit by very much. At this point, the main reason to keep working is for the earnings themselves and the extra retirement security those earnings can bring (plus the psychic rewards, of course).

People with less than 35 years of earnings—such as parents who took time out of the work force to stay home with children – have more of an opportunity to raise their Social Security benefit. If you are interested in seeing how continued earnings may raise your Social Security benefit, use the Retirement Estimator at www.ssa.gov/estimator.

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Social Security Planning for Couples: Maximizing Survivor Benefits

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A key benefit of Social Security that most people never think about are the payments to survivors following the death of the primary wage earner. These payments can be life-saving for young families, of course, but they can also be very important in determining your retirement income.

One of the first things to understand when you are thinking about when to claim Social Security is that after the death of the higher-earning spouse, the higher benefit will transfer over to the surviving spouse (her own benefit will stop) and continue to be paid for as long as she is alive.

Because the higher-earning spouse's benefit is determined by the age at which he initially claimed his benefit, the higher-earning spouse has direct control over the amount of his spouse's eventual survivor benefit. He can maximize that benefit by delaying the start of his benefit to age 70.

Lifetime benefits under different life expectancies

Steve and Sarah are a hypothetical boomer couple. Steve was a high earner all his life and will receive a Social Security benefit of $3,000 if he applies for it at his full retirement age of 67. This is his primary insurance amount, or PIA.

If he files for Social Security at 62, he will receive 70% of $3,000, or 2,100. If he delays the start of his benefit to age 70, he'll receive 124% of $3,000, or $3,720, not counting cost-of-living adjustments between now and then.

Like many boomer women, Sarah had some years where she worked part-time or not at all. Her PIA is $1,600, or a little more than half of Steve's.

Let's imagine two outcomes for Steve and Sarah. One is that they ride off into the sunset together and both live to age 95. The other is that Steve dies at age 70 while Sarah lives to age 95. To be honest, Sarah's early death would have less of a financial impact on Steve—at least from a Social Security planning standpoint—so we're mainly looking at how to take care of Sarah after Steve dies. It is his life expectancy that's the key function here because he has the higher Social Security benefit.

Under the first outcome—they both live to age 95—they will receive a total of $1,868,093 if they both apply for benefits at 62, assuming 2% annual cost-of-living adjustments and no change in the current Social Security benefit formula.

If they wait and apply at 70, they'll receive a total of $2,676,480, a difference of $808,387. This can be considered the value of Social Security's longevity insurance—that is, protection for both spouses in case they both live to age 95. (In present-value terms, with a 0% COLA, cumulative benefits are $1,309,754 under the early-claiming scenario vs. $1,748,000 under the later-claiming scenario—a difference of $438,246.)

Now let's look at the second outcome: Steve dies at age 70. After Sarah reports his death, her Social Security benefit will stop and she will begin receiving her survivor benefit, which will equal Steve's benefit at the time of his death. The amount of this survivor benefit will depend on when Steve originally applied for his benefit. So the value of Social Security's life insurance to Sarah will depend on that decision.

Under the early-claiming scenario, total benefits with COLAs will be $1,338,309 at Sarah's age 95, versus $1,865,518 under the later-claiming scenario, a difference of $527,209. (Or, with a 0% COLA, $1,057,504 vs. $1,249,567, a difference of $192,063.)

So the insurance is clearly worth more if they delay. But unlike a traditional insurance policy, they didn't have to pay anything for this extra insurance. All Steve had to do was delay his benefit. By waiting until age 70 to start his Social Security benefit, he is gaining over a million dollars worth of longevity insurance in case he lives to age 95, plus an extra $600,000 worth of life insurance in case he dies at 70.

The only time the delayed filing strategy would not pay off is if Sarah also dies early. If Sarah were to die at age 70, the delayed filing strategy would cause them to forego $344,965 in benefits they could have received from age 62 to 70. This may be seen as the "cost" of both the longevity insurance (if Steve lives to 95) and the life insurance (if Steve dies at 70). But this cost goes away if Sarah lives past the classic break-even age of 78. After that, there is no cost to delaying benefits.

The traditional break-even analysis

Under the traditional break-even analysis, an individual must decide between two claiming scenarios: start benefits early at a lower amount, or start benefits later at a higher amount.

The break-even age is the age at which total cumulative benefits from the later-claiming scenario begin to exceed total cumulative benefits from the earlier-claiming scenario. If you are comparing 62 to 70, the break-even age is about 78.

So if you think there is a good possibility that you will live longer than 78, consider delaying your benefit to age 70.

But when you are married, the analysis changes. Then you have to consider the potential life expectancy of the longer-lived spouse. Because Steve's benefit will prevail regardless of who dies first (because his is the higher benefit), they will want to maximize that benefit. So when determining Steve's claiming age, it is not necessary to make a guess on Steve's life expectancy.

What matters is Sarah's life expectancy. The odds are very good that she will live past age 78. In any case, it is just good risk management to implement the strategy that will ensure financial security in case she does make it into old age.

What does this mean for the couple?

Steve should delay his benefit, even if he has a short life expectancy. In fact, a short life expectancy is all the more reason for him to delay his benefit, because Sarah will be transferring over to her survivor benefit all the sooner.

If Steve dies before he claims his benefit at 70, Sarah's survivor benefit will include the delayed credits Steve's benefit had been accumulating up until the time of his death. But if he claims at 62 thinking he might as well get as many checks as he can before he dies, he will leave Sarah with a reduced survivor benefit.

Now, if they really thought Steve might die at 70, Sarah could file for her benefit at 62. This would give her $119,294 in benefits from age 62 to 70, before she switches over to her survivor benefit.

But there is a trade-off: if Steve ends up living to age 95 (meaning it will be many years before Sarah transfers over to her survivor benefit), they'll end up with lower total benefits: $2,391,546 if she files at 62 vs. $2,391,546 if they both delay. In this case, where you are considering whether Sarah should file for early benefits while Steve delays, Steve's life expectancy does matter.

If he has a short life expectancy, he should still delay his benefit in order to maximize the survivor benefit for Sarah. But Sarah can go ahead and file at 62 because her reduced benefit will not be permanent.

On the other hand, if Steve has a long life expectancy, Sarah will be sticking with her benefit for many years before switching to the survivor benefit, so they'll want to maximize her benefit by having her delay. The bottom line: Steve should be thinking about Sarah's life expectancy when he claims his benefit, and Sarah should be thinking about Steve's life expectancy when she claims her benefit.

Fast forward 30 years

We've been talking about the value of Social Security in terms of cumulative benefits. But to surviving spouses the income is often more important.

Sarah is 90 years old and sitting on the front stoop of her assisted living facility with her other widowed friends. They are comparing their monthly Social Security checks. Sarah recalls back when she and her late husband Steve were talking with their financial professional about when to claim Social Security benefits.

It was tempting to start Social Security at 62, but their financial professional showed them how much more they would receive if they delayed the start of their benefits to age 70.

Sarah shares with her friends that her monthly Social Security benefit, with all the cost-of-living adjustments, is now up to $6,616. That's because when Steve died right after claiming his benefit at 70, his higher benefit transferred over to Sarah. Because he had delayed his benefit, her survivor benefit included all the delayed credits that had accrued to him between full retirement age and age 70. And then the benefit was raised each year by annual cost-of-living adjustments.

"I wish my husband had done that," Sarah's friend Janice remarks. "My monthly check is only $4,050. It's hard to get by on that amount now that everything is so expensive." Sarah empathizes with her friend, but can't help feeling satisfied that her Social Security check is nearly twice as high as Janice's.

The higher income Sarah is receiving now is the amount of income she is receiving in her old age and her ability to make ends meet without worrying about running out of money. She knows the income will continue for as long as she lives, and she's grateful that her late husband and their professional had the forethought to maximize her Social Security income by delaying the start of benefits—even when it seemed counterintuitive.

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Social Security Claiming Under the New Rules

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On November 2, 2015, the Bipartisan Budget Act of 2015 was passed into law. In addition to budgetary provisions, the law closed certain "loopholes," which changes the way married couples and divorced individuals may take advantage of Social Security benefits.

Once the law is fully phased in, a high-earning spouse or divorced individual will no longer be able to receive a spousal benefit if his or her own retirement benefit is higher.

In addition, a person may no longer file and suspend for the purpose of entitling a spouse to spousal benefits or to claim suspended benefits in a lump sum at a later date.

Background

When spousal benefits were first introduced in 1939, the idea was to give a low-earning or nonworking wife access to 50% of her husband's Social Security benefit. (Social Security benefits are gender-neutral, but in 1939 it was generally the wife who did not work.)

Two key provisions accompanied this amendment. In order for a wife to receive a spousal benefit, **1)** the husband must be "retired," that is, he must have filed for his Social Security benefit; and **2)** if the wife also qualified for a benefit on her own work record, that benefit must not exceed the spousal benefit. For decades, these conditions had to be met in order for spousal benefits to be paid.

In 2009, two papers were released by the Center for Retirement Research at Boston College suggesting that spousal benefits could be claimed even if those conditions had not been met. In *"Strange But True: Claim and Suspend Social Security,"* the popular "file and suspend" strategy was born. Under file-and-suspend, a husband could file for his benefit, thus meeting the filing requirement for spousal benefits. Then, as long as he was over full retirement age (FRA), he could immediately suspend it to build 8% annual delayed credits.

This voluntary suspension was authorized by the Senior Citizens' Freedom to Work Act of 2000. Its purpose was to allow people who had claimed Social Security and later gone back to work to suspend their benefit to build delayed credits. But when combined with the rule for spousal benefits it allowed a wife to start her spousal benefit even while the husband's benefit is building delayed credits.

The other paper was *"Strange But True: Claim Social Security Now, Claim More Later."* This paper suggested that by filing a "restricted application" for the spousal benefit, a high-earning spouse can receive 50% of the other spouse's primary insurance amount (PIA) while his own benefit builds delayed credits. The rule allowing a person to file a restricted application at full retirement age is in a completely separate part of the Social Security rulebook, and originally had nothing to do with spousal benefits. But when combined with the rule authorizing spousal benefits, it allows a high-earning spouse to receive a spousal benefit for four years, from age 66 to 70, even if his own benefit is higher.

These two strategies—file and suspend and restricted application—have given couples as much as $60,000 in additional Social Security benefits which were not really intended by the law.

With the passage of the Budget Act, these loopholes are being closed. Though file-and-suspend is now closed for good, the changes for "claim now, claim more later" are still being phased in, which means some people will still be able to take advantage of them. To summarize,

- File-and-suspend has been closed as of April 29, 2016. Spousal benefits cannot be paid based on records suspended after the April 29 deadline. Going forward, voluntary suspension will return to its original purpose: Allowing those who already filed but regret it a chance at earning delayed retirement credits.
- Restricted application will be available to you if you had attained age 62 by the end of 2015; that is, you were born on or before January 1, 1954. This will allow you to receive a spousal benefit even if your own benefit is higher.

Note: Many people have been incorrectly using the term file-and-suspend when they really mean restricted application. If you want to receive a spousal benefit off your spouse's work record while your own benefit builds delayed credits, you do not want to file and suspend. Rather, you want to file a restricted application for your spousal benefit.

What to do now

If you were planning on doing the file-and-suspend strategy—that is, you were going to file for your benefit at FRA and immediately suspend it so your spouse could start spousal benefits while your benefit continued to build delayed credits—you are now faced with a choice. You can either go ahead and claim your benefit at FRA so your spouse can start spousal benefits, or you can delay your benefit to age 70 to build 8% annual delayed credits. In other words, you are now faced with a choice between spousal benefits and delayed credits. The spousal benefits may provide income sooner, but the delayed credits may be worth more in the long run, especially if you are trying to maximize survivor benefits for the longer-lived spouse.

If you were planning to file a restricted application for spousal benefits at FRA, and if you were born before January 2, 1954, this strategy remains available to you.

How to file a restricted application

The Budget Act allows anyone who had attained age 62 by the end of 2015 to file a restricted application for spousal benefits when they turn FRA.

This strategy may be appropriate for you if:

- You were born on or before January 1, 1954, **and**
- Your PIA is more than 50% of your spouse's PIA, **and**
- You are planning to claim your Social Security benefit at age 70 to earn maximum delayed credits, **and**
- You would like to receive a spousal benefit of 50% of your spouse's PIA from age 66 to 70 and switch to your own maximum benefit at 70.

If you meet these criteria, you can file a restricted application for your spousal benefit when you turn FRA. To file a restricted application, go to www.ssa.gov and click on "Apply for Retirement." Fill out the application for benefits. Where it asks if you are also eligible for spousal benefits do you want to delay your own retirement benefit, click "yes."

Savvy spousal planning can give married couples tens of thousands of dollars in additional lifetime Social Security benefits, depending on your respective ages and PIAs. But you have to know the rules as they apply to you, and you have to perform certain actions by certain dates, especially now that the Budget Act is phasing out key strategies.

Ask your financial advisor to do a Spousal Planning Analysis which lays out possible strategies for when to claim retirement benefits and how to take advantage of spousal benefits. Incorporate this analysis into your overall retirement income plan with the objective of ensuring an adequate income stream throughout retirement.

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