

# INNOVATIVE STRATEGIES TO HELP MAXIMIZE SOCIAL SECURITY BENEFITS

James Mahaney  
Vice President, Strategic Initiatives



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**“The shift over the past few decades from traditional defined benefit (DB) pensions to defined contribution (DC) plans has transferred the risk of not having enough money to maintain one’s lifestyle throughout retirement from the employer to the individual. Now, more than ever before, maximizing Social Security benefits has become a critical component of retirement income planning. No other vehicle can match the combination of inflation-fighting increases, longevity protection, investment risk elimination, and spousal coverage that Social Security delivers—potentially making it one of the most valuable sources of retirement income. While the Bipartisan Budget Act of 2015 restricted the use of certain Social Security claiming techniques, there are many remaining strategies that can help maximize Social Security benefits and enhance retirement security.”**

Social Security is a valuable, earned benefit that will serve as the foundation of many individuals’ income plans during their retirement years. The decision regarding when to start Social Security benefits is a critical one, and should not be oversimplified. Typical analysis, such as focusing exclusively on a “break-even age” (when benefits received equal the same amount under different age election options), often fails to take into account:

- the value of Social Security Cost-Of-Living Adjustments (COLAs) which, although not guaranteed by law, are a promise made by the government that would be difficult to cancel;
- the tax preferences awarded to Social Security income, compared to withdrawals during retirement from a tax-deferred product (such as an IRA);
- the ability to integrate each spouse’s benefits to provide optimal income and protection;
- the survivor’s benefit, which is passed on to a spouse at death; and
- the ability of Social Security to provide longevity risk protection in the form of retirement income for life—this is particularly important since no one can accurately predict how long they will live in retirement.

This paper discusses the importance of developing a Social Security claiming strategy to help enhance retirement security, and may help assist those who wish to develop such a strategy, despite the elimination of certain claiming techniques due to legislation passed in the Bipartisan Budget Act of 2015. In addition, it highlights ways in which withdrawals from retirement savings vehicles, such as 401(k) plans and IRAs, can be easily wedded to a Social Security claiming strategy to maximize retirement income.

Chapter One explains the basics of Social Security retirement benefits—married couples should pay particular attention to how spousal benefits and survivor benefits work. Chapter Two provides insights regarding what married couples should think about in developing a claiming strategy. Chapter Three covers claiming strategies for divorced individuals, widows, and widowers. Chapter Four focuses on the tax efficiency of creating larger streams of Social Security income in retirement. Chapter Five discusses techniques for bridging the income gap until higher Social Security benefits begin.

# Chapter 1: Social Security Basics

Social Security benefits represent a valuable source of guaranteed income individuals can count as part of a retirement strategy. However, creating a strategy for claiming these benefits is not as straightforward as it may seem. In order to create an optimal strategy, it is important to first understand the different types of benefits and when they might become available.

## Types of Retirement Benefits

### THE WORKER BENEFIT

If you have worked and contributed to the Social Security system for 40 quarters, you are likely eligible for a worker benefit. This benefit, at your Full Retirement Age, is known as the Primary Insurance Amount (PIA). The earliest you can file for your worker benefit is the first month in which you are age 62 for the full month. As a result, most individuals are first eligible for their worker benefit at age 62 and one month. Actuarial reductions apply if you take your benefit prior to your Full Retirement Age. The Full Retirement Age is 66 for those born between 1943 and 1954. If you wait beyond your Full Retirement Age to claim your benefits, a Delayed Retirement Credit of 8% per year will apply. While you are waiting to claim your benefits at any age from 62 to 70, COLAs will also apply and compound over time. For example, if you wait from age 68 to age 69 and the government has declared a 3% COLA, your benefit will grow 11% (8% Delayed Retirement Credit plus 3% COLA) for that year.

### THE SPOUSAL BENEFIT

Assuming that the other spouse has filed for benefits, spousal benefits can begin the first full month that an individual is age 62. Spousal benefits, however, do not earn Delayed Retirement Credits if a benefit is delayed past Full Retirement Age.

This benefit is often thought of as being the greater of what a spouse earns on his/her own work record, or one-half of the other spouse's benefit. Unfortunately, it gets more complicated than that. To understand how the spousal benefit works, let's assume that we have a married couple in which Ken was the higher earner, Mary was the lower earner, and both turn age 62 (and become eligible for benefits) on the same day in 2017. Let us also assume that Ken and Mary's Full Retirement Age is 66.

If Ken has filed for his worker benefit, a spousal benefit *may be* payable to Mary. The simplest way to consider whether Mary is eligible for a spousal benefit when she is younger than 66 is to determine what her worker benefit is at age 66. This amount is her PIA. Ken also has a PIA calculated at age 66. If Mary's PIA at 66 is less than one-half of Ken's PIA at 66, then Mary is eligible for a spousal benefit. The spousal benefit amount will be the difference between Mary's PIA and one-half of Ken's PIA. Therefore, although many might think that Mary is receiving a large spousal benefit based on Ken's work record, she actually is receiving two benefits—her own worker benefit plus the spousal benefit. It bears repeating that Ken must have filed for his worker benefit for Mary to become “entitled” to a spousal benefit. Both a worker benefit and a spousal benefit (if the other spouse has filed) can be taken earlier than age 66 and are subject to actuarial reductions. Worker and spousal benefit reduction amounts are at different rates (with reductions slightly higher for spousal benefits).

To see how the numbers work, let's assume that Ken is eligible for a worker benefit of \$2,000 per month at age 66 (his PIA). Let's further assume that Mary is eligible for her own worker benefit of \$600 per month at age 66 (her PIA). One-half of Ken's PIA (\$1,000) minus Mary's PIA (\$600) leaves Mary eligible for an additional \$400 in the form of a spousal benefit. If Ken and Mary filed at age 66, Ken would receive \$2,000 and Mary would receive \$1,000. Mary's \$1,000 might be thought of as a spousal benefit, but it really is made up of two parts, her own worker benefit (\$600) and her spousal benefit (\$400).

### KEY TERMS

Term	Definition
Cost-Of-Living Adjustment (COLA)	The amount a Social Security benefit increases annually, based on increases in the cost of living
Delayed Retirement Credit (DRC)	The annual amount by which the initial benefit is increased each year, if claiming is delayed past Full Retirement Age
Full Retirement Age (FRA)	The age at which a person may first become entitled to full or unreduced retirement benefits
Primary Insurance Amount (PIA)	The Social Security benefit an individual receives at his/her Full Retirement Age

Following are some important things to consider, as there is often confusion surrounding the payment of spousal benefits. First, Ken could start his worker benefit early, and his \$2,000 would be reduced. For example, he might claim his benefit at age 62 at a reduced amount of \$1,500 per month (75% of his PIA). Even if Ken started his benefits early, Mary could wait until her Full Retirement Age to start all her benefits and still receive the full \$1,000. In other words, the \$400 spousal benefit is not reduced, even though the worker on which they are based (Ken), started his benefits early.

Second, if Ken has filed for benefits, Mary cannot file for only one type of benefit. If she files for her worker benefit or her spousal benefit, she is “deemed” to be filing for both. This holds true because Mary was born after January 1, 1954. If she was born on or before this date, she can choose to file for only a spousal benefit at her Full Retirement Age. See Chapter Two for an explanation as to why this may be beneficial.

Third, if Ken does not file for his worker benefit early, Mary cannot file for her spousal benefit. If Ken waits until age 66 to receive his full, unreduced amount of \$2,000, and Mary wants to file at an earlier point, she can only apply for her worker benefit of \$600, subject to actuarial reductions. For example, Mary could apply for her worker benefit at age 62 and receive \$450 (75% of her PIA). At age 66, once Ken has filed for his worker benefit, she would receive an additional \$400. At that point she would be receiving \$850 (plus any COLAs), not \$1,000. Many are under the impression that Mary’s benefit would increase to one-half of Ken’s benefit once he applied, but this is not the case. By starting her worker benefit early, she locks in a permanent reduction on this benefit. The spousal benefit is added on later in this example. Of course, if Mary took the spousal benefit at any age prior to age 66, then it would be subject to a separate actuarial reduction. For example, if Ken filed for his worker benefit at age 65 and Mary decided to start her spousal benefit at age 65 as well, the \$400 potential spousal benefit would be permanently reduced to \$366 because Mary started 12 months early.

## THE EARNINGS TEST

If you start worker, spousal, or survivor benefits prior to your Full Retirement Age, you will likely be subject to the earnings test. With the earnings test, if you start your benefits early, in every year leading up to the year you reach your Full Retirement Age, \$1 in benefits will be withheld for every \$2 you earn above the limit for that year (\$16,920 in 2017). During the year you reach your Full Retirement Age (age 66 for those born prior to 1955), your benefits are reduced \$1 for every \$3 you earn above a higher limit (\$44,880 in 2017), until the month you reach your Full Retirement Age. At that point, the earnings test disappears. Throughout this paper, when benefits and strategies are described, the assumption is made that the earnings test does not apply.

## FULL RETIREMENT AGE

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: The chart reflects the Full Retirement Age for retired worker and spousal benefits. For survivor benefits, the Full Retirement Age is different for some years of birth.

THE SURVIVOR BENEFIT

Delaying Social Security not only increases an individual’s own benefit, but can also increase the benefit to a surviving spouse. The survivor benefit becomes available to a surviving spouse at age 60, and is calculated as the greater of:

- 1) The surviving spouse’s own then-current benefit, including any COLAs; or
- 2) The deceased spouse’s then-current benefit, including any COLAs. (In this case, the current benefit [#1] drops off whether it was a worker benefit, a spousal benefit, or some combination of the two.)

In essence, the value of delaying Social Security continues, as the higher benefit (which has grown even higher due to COLAs) is passed on at death to a spouse (See Figure 1). This is an important way to help provide income protection to a surviving spouse. It is also worthwhile to note that the smaller benefit drops off at this time. As a result, no matter which

spouse dies first, the smaller benefit will drop off. This lessens the value of delaying Social Security for the spouse with the smaller Social Security benefit, and should be a consideration as to when this spouse should claim benefits.

The transition from traditional defined benefit (DB) pension plans to defined contribution (DC) plans like 401(k)s will make more spouses vulnerable to the risk of running out of money later in life; the qualified joint and survivor annuity, which is mandated in DB plans, is often not part of a DC plan offering. A larger Social Security income survivor benefit could help offset potential healthcare costs, nursing home costs, and everyday expenses. It also helps protect surviving spouses from inflation (since they’ll receive annual COLAs). Plus, it costs nothing more for this additional benefit. Better still, the larger Social Security survivor benefit is taxed at a lower rate than other ordinary income. It’s difficult to reproduce this security for a spouse through other financial vehicles.

Figure 1  
Example: How delaying Social Security can benefit a surviving spouse

	If both spouses start collecting benefits at age 62, and the husband dies at age 82	If the wife collects at age 62, the husband delays benefits to age 70, and he dies at age 82
Initial benefit for husband	\$12,000	\$26,751
Initial benefit for wife (on her own work record)	\$12,000	\$12,000
Benefit that will continue for surviving spouse	\$21,673	\$38,133

Note: The above example is hypothetical and for illustrative purposes only. It assumes both spouses are the same age and that the death of the husband occurs in 20 years, at age 82. COLAs are projected at an assumed rate of 3% per year.

# Chapter 2: Claiming Strategies for Married Couples

A critical part of any Social Security claiming strategy for married couples is integrating Social Security benefits to take advantage of the rules surrounding the claiming of spousal benefits. With the Supreme Court's June 2015 decision in *Obergefell v. Hodges*, married same-sex couples are also eligible for Social Security benefits no matter the state in which they reside.

## DELAY THE HIGHER EARNER'S BENEFIT

Many retirees focus only on the initial Social Security benefit amount and not the "second stage" benefit calculation, the survivor benefit. When this second stage calculation is taken into account, married couples may find that, if retirement income is needed, it's beneficial for the spouse who is eligible for the lower Social Security payments to start collecting his/her own worker benefit early—while delaying the other spouse's benefits.

Then, at the death of the primary breadwinner, the lower-benefit spouse will "step up" to a much higher benefit. In essence, when the primary worker delays benefits, at the death of the first spouse, the smaller benefit drops off and the larger benefit continues. When considering whether to delay Social Security, not only should the worker's expected longevity be considered, but, perhaps more importantly, the spouse's as well.

## DELAY BOTH SPOUSES' BENEFITS

If both spouses expect to live long retirements, or merely wish to protect their income in the event that they do, they may both consider delaying their benefits. The latest age one can delay benefits and receive Delayed Retirement Credits is age 70. Further, as discussed in Chapter Four, there are tax benefits in delaying Social Security. As a result, a strategy whereby both spouses delay Social Security claiming to age 70 may prove more tax efficient than starting benefits earlier.

## DELAY THE HIGHER EARNER'S BENEFIT UNTIL THE SPOUSE'S BENEFIT IS MAXIMIZED

Since a spousal benefit does not grow larger with Delayed Retirement Credits after Full Retirement Age, a married couple may wish to start the higher earner's benefit when the spouse reaches Full Retirement Age, as this triggers the ability of the spouse to claim a spousal benefit.

Using our example couple, let's now assume that Ken is three years older than Mary. Ken has earned a worker benefit, while Mary has no benefit based on her own work record and will rely on a spousal benefit based on Ken's work record. Let's further assume that Ken's PIA is \$2,000 at age 66. Since Mary's benefit is based on Ken's work record, her maximum benefit amount (excluding COLAs) is \$1,000. This is the amount Mary is eligible for at her Full Retirement Age of 66. If she waits

past age 66 to claim her benefit, it does not grow larger with a Delayed Retirement Credit. In addition, she cannot claim this spousal benefit until Ken files for his benefits. Since Mary's \$1,000 benefit does not increase past her Full Retirement Age, Ken could file for benefits at age 69, when Mary is age 66. Ken's worker benefit would be \$2,480 per month since he has earned Delayed Retirement Credits of 8% per year for three years by waiting until age 69 to start his benefits. Mary's spousal benefit, which she can file for since Ken has filed for his worker benefit, would be \$1,000 per month.

## FILE A RESTRICTED APPLICATION

Under the Bipartisan Budget Act of 2015, which restricted the use of Social Security claiming techniques, this strategy is only available to individuals who were born prior to January 2, 1954, and are, therefore, deemed to have turned age 62 in 2015 or earlier. This strategy permits an individual who has reached Full Retirement Age and whose spouse has filed for worker benefits to file for ONLY a spousal benefit, while letting the benefit based on his/her own work record grow until age 70 by earning Delayed Retirement Credits. This process is referred to as filing a restricted application for a spousal benefit. Interestingly, the spousal benefit is not reduced by the individual's own worker benefit, but rather is based on half of the spouse's Full Retirement Age benefit (his/her PIA).

## EXAMPLE

Let's assume Mary's worker benefit is higher than the earlier example, at \$1,200 per month at age 66. If Ken files for his worker benefit of \$2,000 per month at age 66 and Mary decides to file a restricted application for a spousal benefit, she would receive \$1,000 monthly at age 66, while her worker benefit of \$1,200 would grow to \$1,584 (plus COLAs) at age 70.



Mary would switch from the spousal benefit to her worker benefit at age 70. As a result, she would have used the spousal benefit to bridge to a higher worker benefit, which she will receive until either she or Ken dies. Should Ken die first, she would step up his current benefit (\$2,000 plus accumulated COLAs). Although the Bipartisan Budget Act of 2015 limited this strategy to those born prior to January 2, 1954, the other spouse can be born after this date, but he/she must have filed for his/her worker benefits for this strategy to work.

It is worth noting that, in addition to imposing limitations on an individual's option to file a restricted application, the Bipartisan Budget Act of 2015 also eliminated, effective April 30, 2016, a strategy that allowed a worker to "file and suspend" Social Security benefits once Full Retirement Age was reached. This allowed a spouse to begin receiving spousal benefits based on the worker's record, while the worker continued to accrue Delayed Retirement Credits.

## **NON-MARRIED COUPLES ELIGIBLE FOR SPOUSAL AND SURVIVOR BENEFITS**

In 2014, the Social Security Administration updated its rules to recognize some legal relationships as if a marriage exists. These rules, which apply to both opposite-sex and same-sex couples, look to the individual states to see if spousal inheritance rights exist for a given relationship, such as a domestic partnership or civil union. With spousal inheritance rights, a person in a relationship is recognized by the state and treated as a spouse when the other partner dies with no will in place. As a result, those in a civil union or domestic partnership may not have to get married to become entitled to spousal and survivor benefits. A complete listing of the states which recognize spousal inheritance rights can be found on the Social Security website at <https://secure.ssa.gov/apps10/poms.nsf/lnx/0200210004>.

## **KEY POINTS TO REMEMBER**

- To receive spousal benefits, you must have been married for at least one continuous year, as well as be currently married to the worker when the application is filed.
- To receive a spousal benefit based on your spouse's work record, your spouse must have filed for benefits.
- If you were born on or after January 2, 1954, you are deemed to be filing for all available benefits at any point that you file, and cannot choose one type of benefit (e.g., worker benefit) over the other (e.g., spousal benefit).
- You can only file a restricted application for spousal benefits if you were born before January 2, 1954, have reached Full Retirement Age, and have a spouse who has filed for his/her own worker benefits.
- If you start your worker benefits early, they don't increase later in the form of a spousal benefit. A spousal benefit may indeed become available later, but the total benefit will always be lower, since at least a portion (the worker benefit) started earlier than your Full Retirement Age.
- No matter which spouse dies first, the smaller benefit is eliminated and the larger benefit continues.



# Chapter 3: Innovative Strategies for Divorced Spouses, Widows, and Widowers

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Life doesn't always go as planned. A divorce or the death of a spouse may not only result in financial hardship in the short term, but also have lasting effects on retirement security over the long term. Fortunately, Social Security is in place to help. A well thought-out approach can leverage your available options and be the cornerstone of a retirement income strategy.

## IF YOU ARE DIVORCED

The spousal benefit described on page 2 is also available to a former spouse if the marriage lasted 10 years and the individual filing for spousal benefits is currently unmarried. In fact, if you were born before January 2, 1954, the “file a restricted application” strategy on page 5 is available as well. One unique twist with filing for any spousal benefit holds that, if you have been divorced for more than two years, your ex-spouse is not required to have filed for benefits for you to receive spousal benefits. The former spouse merely has to be eligible for benefits (i.e., age 62 and one month).

Keep in mind also that it does not matter if your former spouse has remarried. Both current and former spouses have rights to a “full” spousal benefit as well as a “full” survivor benefit.

Let's look at an example to see how the filing of a restricted application might work for a divorced individual. Carla was born on April 15, 1953, and was married to Jay for 18 years. She left the workforce for most of those years. Jay and Carla divorced, and Jay subsequently married Maria. Carla returned to work and, years later, is now considering retiring. As a result of her being out of the workforce for a number of years, Carla's Social Security benefit is lower than it would have been had she stayed in the workforce, and is \$1,100 per month at her Full Retirement Age of 66 (her PIA).

Since Jay's benefit amount at age 66 (his PIA) is \$2,000, Carla's potential spousal benefit is \$1,000 (one-half of Jay's benefit). If Carla retires and claims benefits prior to her Full Retirement Age, her worker benefit of \$1,100 at age 66 (prior to any actuarial reductions) is higher than the potential spousal benefit of \$1,000 (prior to any actuarial reductions), so only Carla's worker benefit would be paid. If she retired at 64 and immediately filed for Social Security benefits, for example, she would receive \$953 per month (her \$1,100 PIA, reduced for beginning benefits 24 months early). She would receive no spousal benefit. (It would not get added when Jay turns 66).

If Carla instead drew down from her IRA account for two years, from age 64 until age 66, and waited to claim Social Security, she could likely create a much better foundation of income. At 66 (or later), she could file only for spousal benefits, delay her own worker benefits until age 70, and then

switch over. So Carla would draw monthly income from her IRA account from age 64 to 66. At age 66, she would file for only a spousal benefit based on Jay's work record and draw \$1,000 per month for four years from age 66 until age 70. Since Carla filed a restricted application for spousal benefits only, her own worker benefit would be delayed and earn Delayed Retirement Credits of 8% per year. When Carla turns age 70, she could switch over to her worker benefit which would have grown to \$1,452 per month (plus COLAs). By using this strategy, Carla would be able to utilize the spousal benefit (where she wouldn't have otherwise been able to had she started Social Security benefits at age 64) and leverage it to a higher lifetime payout of her own worker benefit. The manner in which Carla claims her Social Security benefits does not have an effect on Maria (Jay's current wife) and vice versa.

Interestingly, Jay will also pass on the same survivor benefit to both. Let's assume 20 years has passed—Jay's benefit has grown to \$3,600 per month, Carla's is \$2,600 per month, and Maria's is \$1,800. If Jay died at that point, both Carla and Maria would step up to Jay's former amount as a survivor benefit and each would receive \$3,600 plus COLAs from that point forward for the rest of their lives.

Those who are divorced and born after January 1, 1954, do not have the option of filing a restricted application for spousal benefits and thus have fewer options to maximize benefits.

If a divorced individual was a lesser lifetime earner than a former spouse, it would likely behoove him/her to ascertain when the former spouse filed, or will file, for benefits since the individual's own benefit will drop off if the former spouse dies first.

For example, let's assume Kathy was married to Christopher, who is eight years her senior. They were married for 12 years and are now divorced. Christopher filed for his benefits at age 67 and is currently receiving \$2,700 per month in Social Security benefits. In addition, Christopher has developed some health problems during the last year. When Kathy turns 62 next year and stops working, she will be faced with a decision as to when to claim benefits. She could wait to file for benefits at her Full Retirement Age and receive \$1,200 per month, or start her benefit at age 62 and earn \$900. She could also delay

claiming past her Full Retirement Age. While the reduced amount at age 62 is actuarially equal to the amount she would receive if she claimed at age 66, it ignores the issue that there is a high likelihood that Kathy will receive a survivor benefit in the future based on Christopher's then-current benefit. This survivor benefit would replace her own worker benefit. Weighing the possibilities, Kathy would likely choose to file for her own worker benefits at age 62.

## IF YOU ARE DIVORCED – KEY POINTS TO REMEMBER

- As a divorced spouse, you have the same rights as a married spouse to a spousal benefit, if married for at least 10 years and you are not currently remarried.
- Unlike a married spouse, you become entitled to a spousal benefit as soon as your former spouse reaches eligibility age, regardless of whether your former spouse has filed for benefits. You have to have been divorced for at least two years.
- If you file for benefits prior to your Full Retirement Age, you will be deemed to be filing for both worker and spousal benefits, and the Social Security Administration will pay you whatever you are eligible for when considering both benefits. The spousal benefit will not increase later to a higher amount.
- You can only file a restricted application for only a spousal benefit if you were born on or before January 1, 1954, and you have reached Full Retirement Age. Your former spouse only needs to have turned age 62 (for a full month). When you file a restricted application for a spousal benefit, your own worker benefit will grow with Delayed Retirement Credits and COLAs, and you can switch over to your own higher worker benefit at a later age, such as age 70.
- No matter when you were born, you may step into a survivor benefit based on your former spouse's benefit if it is higher than your own at the time your former spouse passes away. As a result, the longer your former spouse delays the claiming of benefits, the more you may benefit later on in your retirement years.

## IF YOU ARE WIDOWED WHEN YOU RETIRE

If an individual is widowed and has not remarried at age 60, and also has worked for at least 40 quarters during his or her lifetime, he or she will have both a survivor benefit and a worker benefit to consider when building a Social Security retirement income strategy. While conventional financial planning typically recommends claiming the higher of the two benefits, there often is a better way—that is, to integrate the two benefits to provide higher lifetime income.

One strategy is to simply initiate the benefit that provides the greatest monthly value when you initially file.

A second strategy is to claim your worker benefit at age 62 and then switch to the survivor benefit at your Full Retirement Age. For a widow or widower whose own worker benefit, if any, is less than that of a deceased spouse, this strategy allows him or her to take the highest survivor benefit possible. There are no Delayed Retirement Credits for a survivor benefit, so it makes little sense to wait past Full Retirement Age to switch to the survivor benefit.

A third strategy is to claim your survivor benefit at age 60 and then switch to your worker benefit at age 70. Benefits under this strategy do not have to be claimed at these ages—they could start later than 60 for the survivor benefit and earlier than 70 for the worker benefit. That said, starting the survivor benefit at age 60 allows you to leverage Social Security income as early as possible, and delaying the worker benefit until age 70 allows the maximum Delayed Retirement Credits and COLAs to be applied to this benefit.

Let's look at an example, ignoring COLAs for the moment. Assume that Lisa is age 60 and was married to Jim prior to his death. Lisa is entitled to receive a full survivor benefit of \$2,400 per month at age 66 (her Full Retirement Age), or a reduced survivor benefit of \$1,716 per month at age 60. Lisa has also earned her own worker benefit of \$1,500 per month at age 62, or \$2,000 per month at age 66.

Under the first strategy, Lisa could choose to take the \$1,716 reduced survivor benefit at age 60. On the surface, it might appear that this is the best option because not only is \$1,716 higher than the \$1,500 worker benefit Lisa is entitled to at age 62, but she can also start it two years earlier. However, Lisa should consider her other options before making a decision.

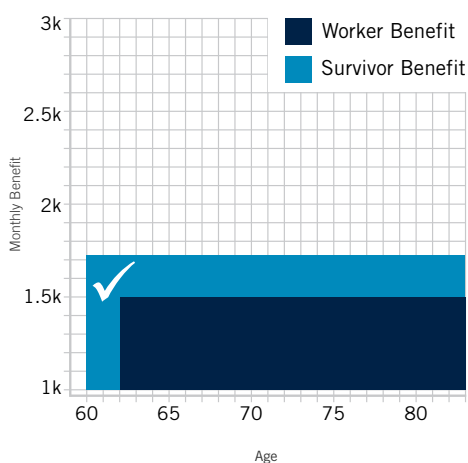
With the second strategy, Lisa could draw her \$1,500 worker benefit at age 62, and then switch over to the full survivor benefit of \$2,400 at age 66. If Lisa has the resources from other retirement accounts to provide herself with income between ages 60 and 62, this method may work very well, since she will ultimately be drawing the higher \$2,400 benefit for the rest of her life.

The third strategy is for Lisa to start her survivor benefit at age 60, and then switch over to her worker benefit at age 70, thereby delaying the worker benefit beyond her Full Retirement Age and maximizing the Delayed Retirement Credits applied to that benefit. Thus, she would start the survivor benefit of \$1,716 per month at age 60 and then

switch to her worker benefit of \$2,640 (the \$2,000 benefit at Full Retirement Age increased by an annual 8% Delayed Retirement Credits for four years) at age 70. This strategy is the same as the first, except that Lisa switches over to a higher benefit at age 70. Why wouldn't she choose this strategy, as opposed to the first one? The answer is likely that she wouldn't choose this strategy only because she is unaware that this option is available to her.

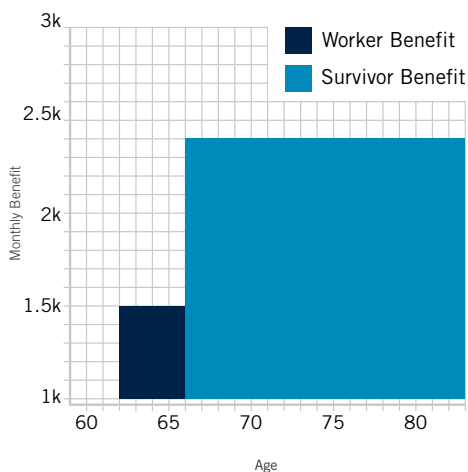
This example, illustrated in Figure 2, is not to imply that the third strategy is always best. Any "optimal strategy" depends on the sizes of the widow's or widower's own worker benefit and the survivor benefit, as well as the individual's own health and financial situation.

**Figure 2**  
**Strategy 1**



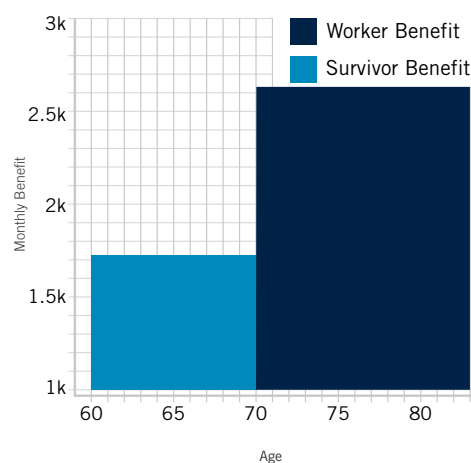
**Claim** the benefit with the greatest monthly value when you initially file

**Strategy 2**



**Claim** the worker benefit at age 62 and **switch** to the survivor benefit at Full Retirement Age (66)

**Strategy 3**



**Claim** the survivor benefit at age 60 and **switch** to the worker benefit at age 70

## IF YOU ARE WIDOWED – KEY POINTS TO REMEMBER

- You may start a survivor benefit at age 60, and/or a worker benefit at age 62, but may not draw both at the same time.
- One strategy is to draw your survivor benefit early, at age 60.
- A second strategy is to draw your worker benefit at age 62 and switch to a survivor benefit at Full Retirement Age.
- A third strategy is to draw your survivor benefit early, at age 60, and subsequently switch over to your own worker benefit at a later age, such as age 70.

# Chapter 4: Decreasing Taxes by Increasing Social Security Income

A retirement income plan should integrate Social Security benefits and other sources of income, such as IRA withdrawals, in a way that optimizes combined after-tax income. When developing a Social Security benefits claiming strategy, it's important to remember that Social Security income is not taxed the same as IRA income. As a result, you can often reduce your taxes by choosing higher Social Security income and lower IRA withdrawals. There are benefits not only from a federal tax perspective, but frequently from a state tax perspective as well, since many states do not tax Social Security income.

## COMPARING HOW IRA WITHDRAWALS AND SOCIAL SECURITY BENEFITS ARE TAXED AT THE FEDERAL LEVEL

Remember that a retiree can choose how and when to take IRA withdrawals and Social Security income. If you choose to take IRA withdrawals first, while delaying the start of Social Security benefits, you're choosing to take higher lifetime Social Security and lower IRA withdrawals. As will be explained below, many individuals who take IRA withdrawals will trigger the taxation of their Social Security benefits that they have already received that year.

Social Security income may be received tax-free. However, once certain income thresholds are met, \$25,000 for singles and \$32,000 married couples, up to 50 cents of every Social Security dollar becomes taxed.

These thresholds are part of the Combined Income formula, also referred to as the Provisional Income formula (See Figure 3). In essence, IRA withdrawals received often push Social Security income over the threshold. When the total income calculated under the Combined Income formula pushes Social Security above a second threshold (\$34,000 for singles and \$44,000 for couples), up to 85 cents of every Social Security dollar can become taxed.

This method of calculating the taxation of Social Security benefits can create very high marginal tax rates on IRA withdrawals when it is received in retirement. In fact, every additional dollar in IRA withdrawals often causes 85 cents of a Social Security dollar also to become taxable. A 46.25% marginal tax rate applies to that one additional dollar of income if the retiree is in the 25% tax bracket:  $(\$1 \text{ (of IRA income)} + [\$1 \text{ (of Social Security income)} \times .85]) \times .25 \text{ (tax rate)}$ . The phenomenon was dubbed the "Tax Torpedo" by one finance journalist.<sup>1</sup>

Nearly all experts make the "false leap" that the tax on Social Security can't be avoided, and therefore assume that 85% of all Social Security will be taxed as ordinary income once singles and couples hit the retirement income thresholds of \$34,000 and \$44,000, respectively. However, this is not true!

Upon closer analysis of the Combined Income formula, you can see that Social Security income only goes into the formula at a 50% rate. All IRA income and even tax-free municipal-bond income counts at 100%.

Figure 3

### What is the Combined Income formula, and how does it work?

The Combined Income formula (also known as the Provisional Income formula) determines how much of a retiree's Social Security benefits are subject to taxation. Up to the thresholds listed below, Social Security benefits are tax-free. Once the first threshold is reached, up to 50% of Social Security benefits are subject to taxation. Once the second threshold is reached, up to 85% of Social Security benefits will be taxed. Listed below are the current first and second threshold limits, respectively.

**Single person: \$25,000 and \$34,000**

**Married couple filing jointly: \$32,000 and \$44,000**

Modified Adjusted Gross Income (MAGI) plus interest from tax-exempt bonds\* plus 50% of Social Security benefits is compared against these thresholds. Note that it is "up to" either 50% or 85% of Social Security benefits that are taxed. See page 11 for how the tax is actually calculated.

<sup>1</sup>"Torpedo Tax Can Cause a Sinking Feeling," *The Dallas Morning News*

\*There are additional amounts that must be included in Modified Adjusted Gross Income. Please consult your tax advisor for details.

So wouldn't it make sense that a retiree could take at least twice the amount of his/her income in the form of Social Security rather than in IRA withdrawals before hitting the "trigger point" where Social Security becomes taxable?

Yes. Actually, a double benefit often occurs for those retirees who would otherwise face the taxation of their IRA and Social Security income. Again, think of trading IRA withdrawals for higher Social Security income. Once you reach age 70 and start taking a much higher Social Security amount, you are taking one additional dollar in the form of Social Security income as opposed to IRA withdrawals.

Better still, you do not pay tax on that Social Security dollar "out of the box," which is not true of the IRA dollar. Instead, the Social Security dollar goes into the Combined Income formula at a 50% rate. So, whereas a 25% tax rate applies, the retiree with IRA withdrawals (and lower Social Security income) is paying taxes as shown in Figure 4 compared to a retiree who, instead of receiving that dollar in the form of IRA income, receives it in the form of Social Security.

### WHY THIS ISN'T JUST A TAX BENEFIT AT LOWER INCOME LEVELS

The example in Figure 4 assumes that the higher Social Security income depicted is taxed at the highest amount — 85% of benefits. However, in reality, the Combined Income formula calculates the tax on the smallest of:

1. 85% of the benefits; or
2. 50% of the benefits plus 85% of any excess over the second threshold; or
3. 50% of the excess over the first threshold, plus 35% of the excess over the second threshold.

Figure 4

### How the combination of IRA income and Social Security income is taxed:

IRA income		\$1
Tax rate	x	25%
IRA tax (A)	=	.25
Additional Social Security subject to tax		\$1
% of Social Security income subject to taxes	x	85%
Taxable Social Security income	=	.85
Tax rate	x	25%
Social Security tax (B)	=	.2125
Total tax in cents (A + B):	=	.4625
Total tax in percentage:	OR	46.25%

Many individuals will therefore pay little or no taxes when they delay Social Security and take higher Social Security income and lower IRA withdrawals. Usually, this results from #3 below as the least of the three tests. Consider that a married couple could have \$64,000 of Social Security income (counting as \$32,000 in the Combined Income formula) before they would ever have "excess over the first threshold."

Although it is not intuitively clear, it is not just retirees who are near the income thresholds of \$25,000 to \$44,000 who will benefit, but individuals who receive much higher retirement income as well. Prudential's research has found that many individuals with after-tax income up to the mid \$90,000 range, can see significant tax savings from delaying Social Security.

### STATE LEVEL TAXATION

Not only does Social Security income receive a tax benefit at the federal level, but 37 states presently do not tax Social Security benefits either. The 13 states that do tax Social Security benefits are Colorado, Connecticut, Kansas, Minnesota, Missouri, Montana, Nebraska, New Mexico, North Dakota, Rhode Island, Utah, Vermont and West Virginia.<sup>2</sup> Of the 13 states, a dozen tax Social Security benefits at a similar or lower level than the federal level, while Colorado fully taxes these benefits.

Therefore, if you live in a state other than Colorado, you will see both a state and federal income tax benefit by creating a retirement income strategy that utilizes larger streams of Social Security income. See Figure 5.

### How every dollar of "delayed" Social Security income is taxed:

Social Security income		\$1
Combined Income formula	x	50%
	=	.50
% of Social Security income subject to taxes	x	85%
Taxable Social Security income	=	.425
Tax rate	x	25%
Social Security tax	=	.1062
Total tax in cents:	=	.1062
Total tax in percentage:	OR	10.62%

<sup>2</sup> Kiplinger <http://www.kiplinger.com/article/retirement/T051-C000-S001-which-states-tax-social-security.html>.

## **WHY EXTENDING TAX DEFERRAL ISN'T ALWAYS THE BEST ROUTE**

Conventional wisdom has held that it's always better to delay taking withdrawals during retirement from a tax-deferred product (such as an IRA) for as long as possible. However, this frequently does not hold true, as the tax benefits from much higher Social Security at both the federal and (often) state level make up for any benefits of delaying the receipt of IRA withdrawals.

The example on the next page depicts the dramatic drop in Adjusted Gross Income (AGI) in a given year for someone who delays Social Security and therefore earns a higher amount after age 70.

The retiree is trading IRA withdrawals for higher Social Security income after age 70.

- In Approach A, the retiree took Social Security early and is taking IRA withdrawals.
- In Approach B, the retiree took Social Security later, and is therefore taking \$25,000 more in Social Security this particular year and \$25,000 less in IRA withdrawals.

This example is being provided to illustrate the dramatic difference in tax being paid after delayed Social Security benefits begin at age 70. To execute this strategy (Approach B), larger IRA withdrawals (than Approach A) would have been taken earlier in retirement to allow the retiree to “afford” to delay Social Security.

Looking at a comparison of the income picture after age 70 is very interesting. Even though the same \$90,000 of pre-tax income is provided, Approach B has an AGI less than half of Approach A. This is the Tax Torpedo in reverse.



Figure 5

### Example: Tax impact of delaying Social Security payments/Married couple filing jointly

Approach A: Taking reduced Social Security benefits early and supplementing with higher IRA withdrawals

Approach B: Delaying Social Security benefits

		Approach A		Approach B
Adjustment amount			\$25,000	
IRA income		\$45,000		\$20,000
Social Security	+	\$45,000	+	\$70,000
<b>Total pre-tax income</b>	=	<b>\$90,000</b>	=	<b>\$90,000</b>
AGI		\$45,000		\$20,000
Plus tax-exempt income	+	\$0	+	\$0
<b>Modified AGI</b>	=	<b>\$45,000</b>	=	<b>\$20,000</b>
Social Security benefits		\$45,000		\$70,000
<b>Test 1</b>	85% of Social Security benefits (Total test 1)	\$38,250		\$59,500
<b>Test 2</b>	A) One-half of Social Security benefits	\$22,500		\$35,000
	B) Combined income	\$67,500		\$55,000
	C) Less second threshold	\$44,000		\$44,000
	D) Excess above second threshold (B – C)	\$23,500		\$11,000
	F) 85% of excess (D x 85%)	\$19,975		\$9,350
	<b>Total test 2 (A + F)</b>	<b>\$42,475</b>		<b>\$44,350</b>
<b>Test 3</b>	B) Combined income	\$67,500		\$55,000
	G) Less first threshold	\$32,000		\$32,000
	H) Excess above first threshold (B – G)	\$35,500		\$23,000
	I) 50% of excess above first threshold (H x 50%)	\$17,750		\$11,500
	J) 35% of excess over second threshold (D x 35%)	\$8,225		\$3,850
	<b>Total test 3 (I + J)</b>	<b>\$25,975</b>		<b>\$15,350</b>
Amount includable in gross income (Least of the three tests)		\$25,975		\$15,350
Adjusted Gross Income		\$70,975		\$35,350



Figure 6  
To Generate \$90,000 of Income,  
Which Approach Makes More Sense?

Approach A

Chart View   Table View

Non-taxable SS income	Taxable SS income	Taxable IRA income
\$19,025	\$25,975	\$45,000

Approach B

Chart View   Table View

Non-taxable SS income	Taxable SS income	Taxable IRA income
\$54,650	\$15,350	\$20,000

The tax advantages of taking more of your retirement income as Social Security are substantial for many individuals. Conventional wisdom on the “when to start Social Security” discussion has overlooked these tax advantages and must be revisited.

# Chapter 5: Bridging the Income Gap to Higher Social Security Benefits

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**As you can see, there is tremendous potential tax, income, and spousal protection from delaying Social Security benefits and maximizing the use of spousal and survivor benefits.**

However, delaying the initial claiming of Social Security benefits doesn't mean you have to delay receiving retirement income. Individuals can tap their IRAs, 401(k)s, or other investments to provide bridge income from the time that they retire until the time that their higher Social Security benefits kick in. There are a number of ways that you can provide yourself with bridge income during this period. Period-certain immediate annuities can provide a consistent cash flow. Alternatively, deferred variable annuities with a guaranteed minimum withdrawal rider work well in providing income streams and often provide more flexibility than immediate annuities. Many 401(k) plans now allow for guaranteed minimum withdrawal benefits or systematic withdrawal capabilities.

Keep in mind that Social Security amounts may change over time for a spouse, as he or she may start a worker benefit at age 62, step up to a higher spousal benefit at age 66, and then inherit an even higher survivor benefit when his or her spouse dies.

If you do decide to delay Social Security benefits, make sure to properly plan by:

- Remembering to maximize possible spousal benefits. If born on or before January 1, 1954, utilize the opportunity to file a restricted application only for a spousal benefit once reaching Full Retirement Age.
- Comparing potential Social Security start ages on an “apples to apples” basis and treating inflation adjustments fairly. Consider that your annual Social Security statement shows starting amounts at different ages in “today’s dollars,” while almost all financial planning is done in “future dollars.”
- Remembering that the higher Social Security benefit continues when the first spouse dies. No matter which spouse passes away, the smaller benefit will be eliminated.
- Always considering the insurance nature of Social Security retirement benefits, as it provides inflation-adjusted income for as long as you (and your spouse) will need it.

## CONCLUSION

Creating a strategy that maximizes Social Security benefits is an important part of effective retirement planning. While the Bipartisan Budget Act of 2015 eliminated the use of certain claiming techniques, opportunities are still available to create larger streams of Social Security income. Not only can this reduce taxes, but it also can help hedge against the risk of running out of money due to a long retirement.

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