The Great Debate
New study shows benefits of delaying Social Security and taking IRA distributions early

To many, the great debate is whether and when Social Security and Medicare will go belly up. That debate began once again this week with the release of the Social Security Board of Trustees and the Medicare Fund Trustees latest reports.

But to would-be retirees, the great debate is something more pressing. It's whether and when to take Social Security. And now that debate is about to take a new twist. The authors of a new 44-page paper presented this week at the Wharton Impact Conference argued that previous research on when retirees should take Social Security has failed to recognize the critical factors — tax benefits, survivor benefits, projected Cost-of-Living Adjustments (COLA) benefits, and spousal benefits — that greatly impact the discussion on when it is most beneficial to start Social Security benefits.

James Mahaney and Peter Carlson of Prudential Retirement, the authors of "New Approaches to Retirement Income Phasing," said taxes can have a dramatic effect on the financial security of retirees, yet the taxation caused by IRA withdrawals and the interaction with Social Security has been largely misunderstood.

What's more, the author's said changes made under the Senior Citizens' Freedom to Work Act of 2000 make delaying Social Security for married couples much more favorable. Plus, a higher Full Retirement Age (FRA) and higher Delayed Retirement Credits (DRC) are now in effect.

"Social Security take-up decisions should be more closely analyzed," the authors said in their report. According to Mahaney, Social Security — despite the Trustees recent report — should play a larger role than it does now in the retirement income strategies for most Americans. "As a source of income, Social Security will more often be the preferable source of income due to its tax-favored status, inflation protection, survivor protection, longevity protection and the lack of cost to the recipient during retirement," the study said. By contrast, IRA income faces investment risk, expenses and purchasing power risk and results in self-insuring at a high cost. "Essentially, when an individual chooses to delay Social Security vs. taking Social Security early, that individual will be trading higher IRA income for higher Social Security income over the course of his/her retirement."

In their study, the authors point to a number of factors that must be weighed in a world where fewer and fewer retirees have a traditional pension plan and more and more retirees have just Social Security and a 401(k)/IRA.

Here are some excerpts:

Social Security—Subtle changes with major impact: Changes enacted under prior Social Security reform introduced in 1983 are now phasing in. Importantly, the FRA is now 66 for those who will become eligible for Social Security over the next several years. Changes to the FRA have increased the penalty for taking Social Security early. What was once a 20% decrease in the initial benefit amount when starting Social Security at age 62 is now a 25% decrease. The compounding effect of COLAs over longer life expectancies makes these cuts even deeper. In addition, the "reward" for delaying Social Security past the FRA is now 8% per year for those turning 62 in 2005 and later. Again, the compounding effect of COLAs throughout retirement adds to the value of delaying. It is also unlikely that most individuals realize that even when they are delaying benefits, that they are receiving credit for COLAs during the period for which they are delaying the start of Social Security.

Value of COLAs: In nearly all break-even analyses, COLAs are ignored… Although, COLAs are not guaranteed by law, we believe that COLAs should be considered as part of the value proposition of weighing whether to delay Social Security benefits…. Due to much longer life expectancies than in the past, the compounding value of COLAs should be considered, especially as these benefits often can be passed on to a widow at the death of the worker. When future projected COLAs are factored in, an individual retiring with a first Social Security check payable in 2006 at age 62, has a crossover age of 78 when comparing to waiting until age 70 to begin initial benefits. What should be given strong consideration is that the longer the retiree lives, the higher the return delayed Social Security income provides… No matter what inflation rates occur in the future, COLAs on Social Security retirement benefits provide low cost inflation protection that no private product can duplicate without significant cost.

Survivor protection: The value of spousal and survivor benefits is another area where Social Security has not been adequately valued… The survivor protection offered under Social Security should be an important consideration in deciding when to take Social Security. Whenever a member of a married couple dies, the highest individual benefit at that point in time is the one that continues to be collected by the surviving spouse. In other words, it doesn't matter who dies first, the worker or the spouse, because the lower benefit drops off. Thus, when a primary worker delays Social Security, the higher delayed benefit plus any compounding COLAs are passed on to the widow at the worker's death, if that benefit is higher than the one she is currently receiving. If an individual still decides to start Social Security early at age 62, the potential benefit to his widow is also reduced at the higher penalty incurred with the FRA at 66 and climbing…since the higher Social Security benefit is passed on to a surviving spouse at the worker's death and the lower spousal benefit is dropped, it is often more beneficial to start the spouse's benefits earlier. Therefore, absent specific individual health considerations, it will often be beneficial to start the spouse's benefits first.

The tax preferences of Social Security: Social Security income is often much more tax efficient than IRA income under current tax law. In fact, we believe that the tax benefits of Social Security have been greatly under-appreciated. Prior research makes the assumption that Social Security income earned over the Combined Income thresholds will cause Social Security to be taxed at a rate on up to 85% of the benefits paid and that the source of income does not matter. Actually, this assumption will not necessarily hold true for the majority of individuals and mandates a closer look, especially in light of the question of when to initiate Social Security benefits.

The expense advantage of Social Security: The "safe withdrawal rate" … uses Monte Carlo simulation of historical rates of return to predict the probability of successfully providing an income stream over a 20-, 30- or 40-year retirement horizon. Unfortunately, investment expenses and fees are often ignored in this discussion… investment expenses can have a profound impact on withdrawal rates. Since individuals increasingly bear the burden of providing income throughout retirement, expenses drained from a portfolio also will reduce future retirement income and thus have emerged as a risk to retirement security.

Social Security options and customization are available: As defined contribution plans replace defined benefit plans, the role of the traditional Social Security benefit will become that much greater. The majority of retiring Americans will have a much greater present value of wealth tied up into Social Security than from their own personal retirement savings. Consider that a married high earner in 2006 would retire with over $25,000 of Social Security income between the worker and the nonworking spouse if they started collecting right away at age 62. Even assuming no fees, ignoring the tax efficiency, and assuming a 4% safe withdrawal rate, that couple would need $625,000 of savings just to provide a similar pre-tax benefit with 90% confidence that income will last 30 years. Individuals have the ability to start different pieces of Social Security at different times. A working spouse could start her own worker benefits at age 62, add the additional spousal benefit when her husband reaches FRA, and then eventually assume an even higher widow's benefit at the death of her spouse. Once individuals customize a strategy to optimize their potential Social Security benefits, they can structure an IRA strategy to provide income during the 'bridge period' from retirement to the delayed Social Security date of the primary worker. For a married couple, which started a spouse's Social Security benefit earlier, this income could be "carved out" of the IRA income needed.

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