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Social Security Planning for Retirement

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Tax-Wise Ways to Win the Waiting Game

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For seniors, deferring Social Security until the last start date — *age 70* — is a goal comparable to winning the Stanley Cup or hoisting the Lombardi Trophy. Monthly benefits are maxed, any subsequent cost-of-living-adjustments (COLAs) will apply to the larger base, and the surviving spouse will get the plumpest possible lifelong payout. There even may be tax advantages to waiting, as taxation of Social Security benefits follows a formula that counts only half of Social Security benefits versus full-dollar inclusion of other gross income.

I deal with the "when to claim" question every single day, and I point out the advantages of waiting. Seniors are better off deferring Social Security benefits at least until age 67, now full retirement age (FRA), if they still have substantial earned income, or ideally to age 70. The catch, of course, is that many individuals retire or semi-retire prior to claiming Social Security, so their current income may be diminished.

If individuals forgo Social Security during their 60s, where will they get money to pay for living expenses?

Bracket Busting

At our firm, we often suggest that clients draw down accounts that would generate taxable distributions, all the way to age 70, when Social Security would begin. For now, at least, this approach allows people to pay taxes while they are "on sale," with relatively modest federal income tax rates in effect through 2025. For this year, a married couple filing jointly can have almost $384,000 in taxable income (after deductions) and remain in the 24% tax bracket or would be in the 22% bracket with taxable income up to $201,000.

Most individuals approaching Social Security own tax-deferred accounts, especially traditional IRAs. That's where the money is. No matter what they hold in their IRAs (stocks, bonds, mutual funds, CDs, annuities, etc.), spending down the IRA while allowing Social Security income to grow can be a savvy solution.

Retirement Reality

Example: To see how this approach might work in real life, consider married couple Sue and Ted. They were born in 1959 and 1960 respectively, so their current ages are 65 and 64. Both have stopped working but have not yet filed for Social Security.

If they both file now, their Social Security retirement benefit would be $2,261 a month ($27,132 a year) for Sue and $1,968 a month ($23,616 a year) for Ted. In addition, Ted has a military pension of $780 a month ($9,360 a year). Thus, claiming Social Security now would raise their current retirement income from $9,360 a year to about $60,000 a year, or around $35,000 if only one spouse starts Social Security.

Between them, Sue and Ted own five annuities from different companies; each annuity has an income rider attached. These annuities have been in force for about 5 years, allowing the couple's future income to grow on a guaranteed basis until they turn on the income riders for lifetime payments. Rider details vary, but they allow the owners to choose lifetime income at any point: it's as easy as filling out a simple form or making a phone call to the company.

Pulling the Trigger

After our discussions about claiming Social Security, Sue and Ted decided to trigger the annuity riders for joint lifetime income. Once all the riders have been executed, the couple will receive $2,150 a month ($25,800 a year)

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as long as either spouse is alive. About 85% of the income from the annuities will be from tax-deferred IRAs, resulting in taxable income now, and the 15% remainder will be untaxed cash flow from a Roth IRA.

This money from their annuities will allow them to delay Social Security until age 70. Assuming a five-year wait for Sue and six years for Ted, these delays probably will increase Social Security benefits by more than 40%, at a guaranteed rate of nearly 8% a year. Once those benefits begin, the combined amount would top $70,000 a year, not counting any COLAs in the interim, and subsequent COLAs will continue to increase this income.

Triggering the income riders from the annuities now will provide the income currently needed, allowing an increase to future Social Security payments by waiting. If the need for additional income arises, due to the higher cost of living, the spouse with the lower Social Security benefit can start then while the spouse with the higher benefit defers as long as possible. The goal is to use existing assets to provide immediate income, paying taxes while they are on sale, and allow at least one spouse's delayed Social Security income to increase until a later claim. This plan also will deliver the larger lifetime Social Security payment to the surviving spouse.

For now, the combined annuity payments, after tax, will more than cover the couple's living expenses while Social Security is delayed until age 70. Sue and Ted are using a portion of the after-tax income to buy two permanent life insurance policies, each of which has a $200,000 death benefit. As an added feature to their plan, Sue and Ted are choosing life insurance policies with long-term care (LTC) riders, increasing their LTC benefits.

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IRAs Down, Tax-Free Cash Coming

Continuing on with hypothetical Sue and Ted, triggering the annuities held in tax-deferred traditional IRAs will reduce the required minimum distributions (RMDs) from those accounts that they eventually will owe, at some point in their 70s. This reduces the risk of potential future hikes in tax rates.

Also in the future, the surviving spouse will receive a $200,000 death benefit, income tax-free, from one of the life insurance policies. That will help offset the widow(er)'s loss of income resulting from going from two Social Security payments each month to one payment per month.

At the death of the second spouse, their heirs will receive $200,000, income tax-free, from the other life insurance policy. This can deliver a reduced tax burden for non-spouse beneficiaries by helping them meet tax payments due for distributions from inherited IRAs, squeezed into a 10-year time frame.

Assessing Annuities

The Sue-and-Ted example in this article illustrates annuities as the assets used for taxable IRA distributions. I'm impartial as to whether or not annuities are used for these taxable withdrawals.

However, I often use them with our clients. We write many annuity contracts, with about 75% of the dollars involved held in pre-tax IRAs, 401(k)s, 403(b)s, etc.

In my part of the world, people nearing age 65 are basically done with *risk*. They want safety and guarantees, in order to avoid another 2008 or 2022, when equities fell sharply. As a result, they choose holdings that protect their assets, whether it's after-tax money or tax-deferred.

That is why annuities are so attractive. The risk tolerance is going down and the need for income is going up. Annuities are a great fit in that situation. With an income rider attached, the owner can trigger income now, pay taxes while rates may be reasonable, allow Social Security benefits to grow, and never run out of money from the annuity. An annuity even can provide for joint lifetime income from an IRA.

The majority of my clients do own annuities, inside and out of retirement accounts. When they choose to defer their Social Security benefits, they also may decide to activate the income riders from their annuities to bridge the gap of income needed, from age 62 to age 67, in order to avoid postponed benefits while they're still working before FRA, or from age 62 to age 70, to get the largest possible lifelong payments.

Advisor Action Plan

- When clients are in their late 50s and early 60s, illustrate the advantages of delaying Social Security at least until age 67 and possibly to age 70.
- If an anticipated shortfall of cash flow will prevent such waiting, determine if other assets might be liquidated to bridge the gap.
- Because most people do most of their retirement savings in tax-deferred retirement accounts, those accounts are often the ones most likely to be used to provide interim cash flow.

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Tapping pre-tax accounts may be especially appealing in 2024 and 2025, with relatively low tax rates in effect.

- Among IRA assets that could be used to implement this strategy, annuities could be appealing to pre-retirees who shy away from equity risks and prize guaranteed income. ■

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