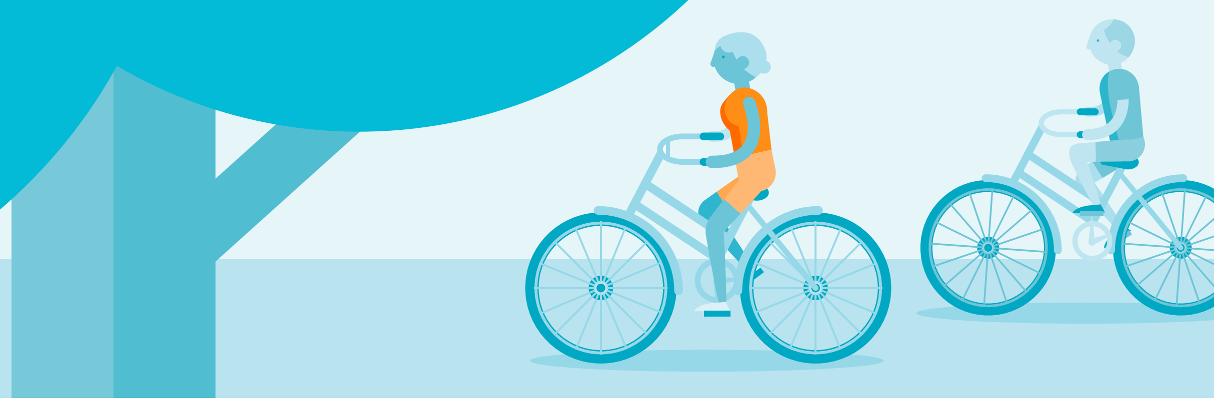
Principal Funds

What You May Not Know About Social Security Retirement Benefits



Executive Summary

What's Inside

Social Security is critical to retirement income planning

Today, Social Security has become the elephant in the room. Individuals know it's there, but don't know much about it and may be afraid to ask. A sad situation given that many individuals will end up relying heavily on this benefit to see them through increasingly longer retirements.

Social Security is far from simple, and we believe individuals need help. Without assistance, they can make costly, often irreversible, mistakes. In our opinion, Social Security is the first step critical to creating retirement income plans.

It can be the difference between individuals retiring successfully or outliving their assets—and it's critical to get it right.

This paper walks you through several factors to consider while determining how and when to elect Social Security—and strategies to optimize it.

Social Security Comes First

The many facets of Social Security

Traditionally, retirement has been seen as a three-legged stool with defined benefit plans, Social Security, and personal savings as the three legs. Today, however, this stool is endangered. First, consider the growing scarcity of corporate defined benefit plans[1]—this fact alone puts retirements in jeopardy as they try to balance on two legs. Then when you add in the growing uncertainty around the future of Social Security, you can envision the stool tipping over at the slightest hint of any other challenge. Finally, when you add to this the fact that individuals are living longer lives than ever before,[2] we believe the uncertainty of retirement today becomes evident. And the critical importance of retirement income planning becomes clear.

For married couples aged 65, one spouse has a 45% chance of living to 90.[2]

Retirements today can easily span 20 – 30 years or more. And investors need advice for how to make their incomes last for their lifetimes. Surprisingly, the most common benefit to all of them may also be the least understood. A complex government social welfare program with many provisions, Social Security is not going away,[3] and studies have shown it'll only become more important to retirees over time.[4]

Social Security can make the difference between individuals outliving their income—or not—though often little thought is put into when and how people claim their benefits.

Here's why it's critically important to discuss these issues now:

1. Having a plan now will give you realistic benefit figures to incorporate into overall retirement income plans.
2. You'll gain a better understanding of the income needed to supplement Social Security.
3. A well-conceived plan for when and how to elect benefits may enable greater income and minimization of taxes throughout retirement.

[1] The Pension Coverage Problem in the Private Sector, September 2012. Center for Retirement Research at Boston College.

[2] Analysis of the 2007 period life table for Social Security Area Population.

[3] Social Security's Financial Outlook: The 2012 Update in Perspective. Center for Retirement Research at Boston College.

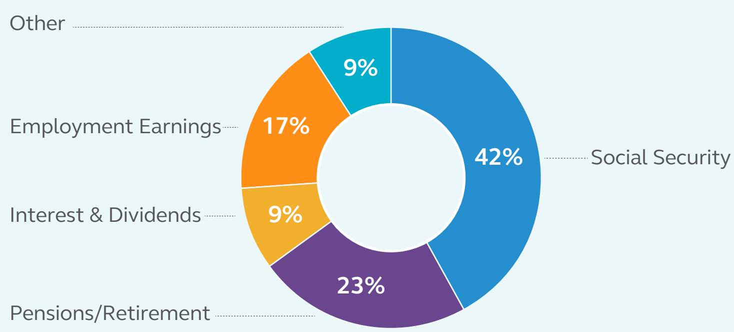
[4] LIMRA Analysis of U.S. Census Bureau's Current Population Survey, March 2012 Supplement.

The income gap

Social Security wasn't designed to replace pre-retirement income. On average, Social Security accounts for about 42 percent of the retirement income taken by retirees today—meaning that more than half of their income will have to come from other sources (see Figure 1). Regardless of how big or small of a part Social Security plays, its role is critically important, and receiving the maximum possible benefit is paramount.

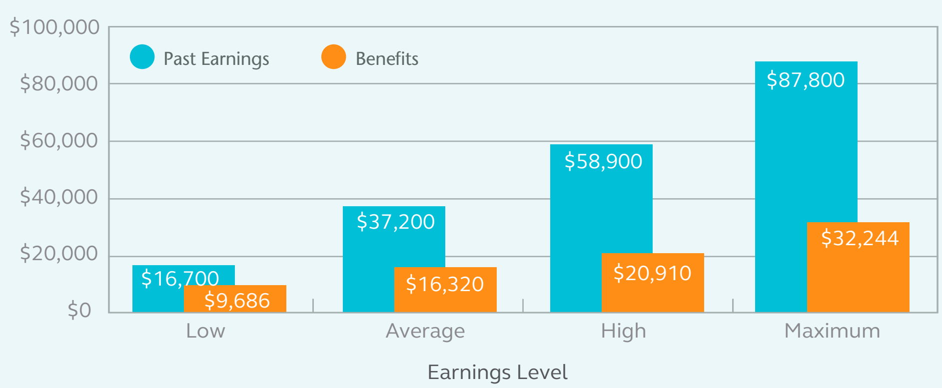
In general, the higher the pre-retirement earnings, the higher the Social Security benefit will be in real dollar terms. However, the higher the earning history, the smaller the percentage of income Social Security will replace. As Figure 2 illustrates, a lower earner receives 58 percent of their previous income in benefits, while a maximum earner receives only 28 percent. There are, however, several strategies that can be employed and these will be explained in this paper.

Figure 1: Source of Retirement Income



Source: LIMRA Analysis of U.S. Census Bureau's Current Population Survey, March 2012 Supplement. Analysis based upon individual's retirement status.

Figure 2: Income Replacement



Source: Board of Trusts 2012. Low earnings are 45 percent of the average wage, high earnings are 180 percent of the average wage. Retirement age 66.

Bridging the Knowledge Gap

Social Security basics

In addition to the income gap that exists with Social Security, there's also a wide knowledge gap. Most individuals are uneducated about how Social Security works and how their decisions regarding benefits can impact their overall financial plan for retirement. For example, a study from the Michigan Retirement Research Center at the University of Michigan showed that:

- Only 48 percent of people responded correctly when asked the earliest possible age to claim Social Security retirement benefits (age 62).
- And only 23 percent correctly responded when asked the maximum age to claim Social Security benefits (age 70). The Social Security Administration won't make a recommendation on electing benefits, so the more individuals know what questions to ask, the better prepared they are for the process.

All's fair in Social Security

Social Security benefits are designed to be actuarially fair at a normal life expectancy —meaning that all things being equal, two individuals born the same year with the same earnings history, who both die at their normal life expectancy, will receive approximately the same total benefit amount over their lifetimes. Even if one elects early and the other elects late. It may be wise, therefore, to base the decision of when to elect on other factors rather than simply trying to get out the money put in.

A maximum of up to four credits can be earned for each year worked. To qualify for benefits (to be fully insured) requires a minimum of 40 credits. In 2017, $1,300 of earned income equaled one Social Security credit.

Primary insurance amount

Almost all benefits are based on the "primary insurance amount" (PIA), which is the benefit a person would receive if he or she elects to begin receiving retirement benefits at his or her Full Retirement Age (FRA). At this age, the benefit is neither reduced for early retirement nor increased for delayed retirement.

Figure 3 provides an overview of Social Security benefits and the general requirements for claiming them. Using the information in this paper and tools on the Social Security website (ssa.gov), you can gain a more complete understanding of the benefits available.

Cost of living increases

Social Security benefits are typically subject to cost of living adjustments (COLA) each year—helping to offset inflation.

Figure 3: Social Security 101

Type of benefit	How benefits are determined	Who qualifies	When can it be claimed
Individual Benefit	Benefits are based on the average of the 35 highest earnings years. (Indexed for inflation.)	U.S. workers who've earned at least 40 credits (governmental employees may not qualify).	• Age 62 for reduced benefits. • Full Retirement Age (FRA—see Figure 4 for definition) of full benefits. • Age 70 for delayed benefits.
Spousal Benefit	Benefits are an amount equal to half of their spouse's FRA.	Spouses who have been married at least one year.*	Once the first spouse has elected their benefits, spousal benefits can be claimed at: • Age 62 for reduced benefits. • FRA for full spousal benefits.
Survivor Benefit	If the deceased spouse's benefit was greater than the survivor's benefit, their benefit is increased to that amount if FRA or older. If under FRA, the amount would be reduced.	Widows or widowers.*	Widow or widower can claim benefits at: • Age 60 for reduced benefits. • FRA for full retirement benefit.

* Ex-spouses who were married at least 10 years and haven't remarried can also claim spousal benefits (even if the worker they are claiming on has remarried). If not married or married after age 60 they may also qualify for a survivor benefit.

To elect or not to elect

Workers should review their statement or access the online Social Security Retirement Estimator, both provide an estimate of what their benefits will be if they choose to retire at their Full Retirement Age (FRA), at 70, or at 62. As Figure 4 illustrates, Full Retirement Age varies depending upon the year of birth.

Additionally, Figure 4 illustrates the impact on payments and shows how much can be lost or gained by either electing early or late. Importantly, all qualified workers and spouses can claim benefits at age 62, but doing so will reduce their benefits permanently—the exact amount varies depending on birth year and year of election. For example:

- An individual born in 1952 can elect benefits in 2014, but the benefits will be reduced by 25 percent from what they'd be at FRA.
- If the same individual elects to wait until their 70th birthday in 2022, their benefit will have grown by an additional 32 percent from what it would have been at FRA.

It's worth noting these figures don't include any cost of living adjustments.

The majority elect early

Given the large deductions for electing early and the guaranteed 7 – 8 percent annual increase for delaying election, it's somewhat surprising so many individuals are receiving reduced benefits. Perhaps people claim them early simply because they can. Perhaps they're concerned about the future of Social Security. There are endless reasons why individuals take their benefits early, but there may be one commonality—they likely haven't considered the impact this decision will have on their monthly income for the rest of their lives.

According to the Social Security Administration, 73% of retired Americans are receiving reduced benefits.

Source: Annual Statistical Supplement, 2013.

Figure 4: When to Take Benefits? Early vs. Late

Year of birth	Normal or Full Retirement Age (FRA)	Percent reduction if elected at 62	Yearly increase if retirement delayed year of birth beyond FRA
1937 or earlier	65	20%	7%
1938	65 and 2 months	20.83%	7%
1939	65 and 4 months	21.67%	7%
1940	65 and 6 months	22.50%	7%
1941	65 and 8 months	23.33%	7.5%
1942	65 and 10 months	24.17%	7.5%
1943 – 1954	66	25%	8%
1955	66 and 2 months	25.83%	8%
1956	66 and 4 months	26.67%	8%
1957	66 and 6 months	27.50%	8%
1958	66 and 8 months	28.33%	8%
1959	66 and 10 months	29.17%	8%
1960 or later	67	30%	8%

Planning Basics

Planning tips

When determining the best method for electing Social Security, there are many questions to consider:

- What's the monthly income need in retirement?
- Are there any health concerns and what's the family history of longevity?
- Will the individual continue working after collecting Social Security?
- Can individual benefits be claimed?
- Is there an entitlement to spousal or survivor benefits?

The answers to these and other questions can help you create a plan that can help optimize Social Security.

How healthy is the individual and what is their family history of longevity?

Longevity is one of the most challenging issues facing retirees today. Currently, the average person has more than a 50 percent chance of living to age 85. While individuals can't know their exact life expectancy, they can tell you whether or not their parents are alive now or the age they lived to be. They can also inform you of any underlying health or hereditary conditions that might cause them to believe their life will be longer or shorter than average.

Increasing reliance on Social Security

As the vast majority of individuals are receiving reduced benefits, it's likely they've not considered longevity issues or their potentially increasing reliance on Social Security as they age and spend down other assets. Consider that:

- Although benefits represent only 26 percent of the income received by retirees aged 60 – 64, this jumps to 38 percent at age 65, 45 percent at age 70, and 51 percent at age 80.[5]
- Retirees who underestimate their longevity now may be increasing the likelihood that Social Security will become their primary income source later on.

[5] LIMRA Analysis of U.S. Census Bureau's Current Population Survey, March 2012 Supplement.

Why wait?

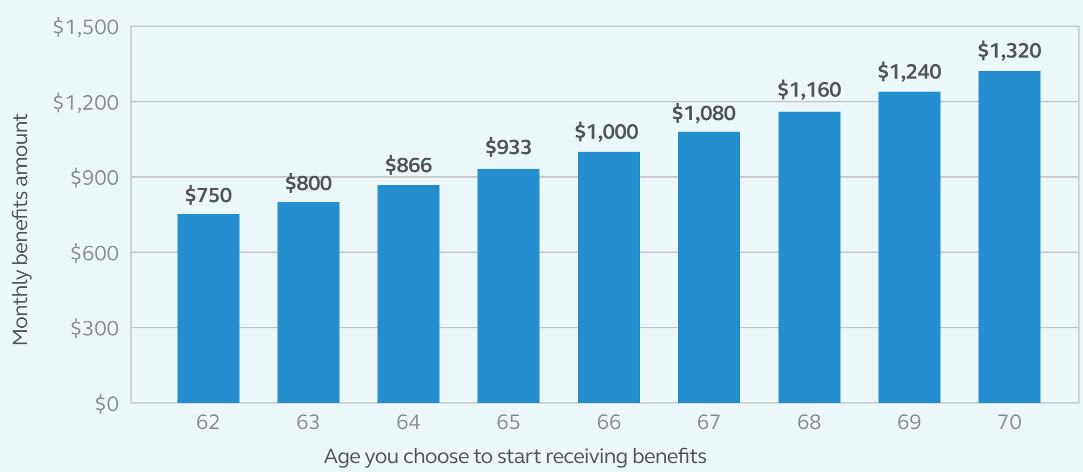
Longevity is an important consideration for determining when to elect benefits. But overall retirement assets are also a critical determinant. Consider that if an individual has fewer retirement assets and a lower risk profile, it may make sense to elect after FRA.

In Figure 5, we examine a worker with Social Security benefits of $1,000 at an FRA of 66.

- If this individual elects at age 62, their benefits are permanently reduced to $750 per month.
- If the individual waits until age 70, the monthly benefit would increase to $1,320.

Of course, there are other considerations as well.

Figure 5: Early vs. Late Retirement



(Benefit amount is determined based on the individual's age in years and months.)

For those who elect early and are still working, every dollar earned over a specific limit will reduce the benefits they can expect for that year.

Continuing to work

It may seem counterintuitive, but working while collecting Social Security can, in some instances, reduce a retiree's benefit. For those who are still working and elect before FRA, every dollar earned over a specific limit will reduce the Social Security benefits they can expect for that year.

As Figure 6 illustrates, if a working individual had elected at age 62, $1 in benefits would've been withheld for every $2 they earned over the income limits. And, it's important to remember that this reduction is in addition to the permanent benefit reduction imposed for electing early in general. Once the individual reaches FRA, however, there's no limit on earnings. Subsequently, if the individual is planning to continue working throughout their early-mid 60s, it may be wise to consider waiting to elect Social Security until their Full Retirement Age. If they do receive a reduced benefit because of earnings, their benefit amount will increase when they reach FRA.

Individual benefits

Another important consideration is what benefits individuals are entitled to claim. For example, those who've never been married are only eligible for their own individual benefits. These workers can make the most of their benefits simply by waiting to elect.

For these individuals, consider:

- Potential longevity.
- Working status.
- Total retirement assets.
- Social Security benefits at different ages.

Figure 6: Working and Collecting

Age	Employment Income 2017 Limits	Considerations
Under Full Retirement Age	$16,920	For every $2 over the limit, $1 is withheld from benefits.
In the year Full Retirement Age is reached	$44,880	For every $3 over the limit, $1 is withheld from benefits until the month in which Full Retirement Age is reached.
At Full Retirement Age or older	No limit on earnings	None

Spousal benefits*

Unlike single individuals, qualifying married people (and in some cases divorced individuals) may receive a higher payment from a spousal benefit. Because spousal benefits aren't mentioned on Social Security statements, couples sometimes don't know about them. As Figure 7 illustrates, this provision enables a qualifying spouse to claim half of their husband's or wife's individual benefit in certain circumstances. It's important to note that spousal benefits max out at 50 percent of the covered worker's FRA benefit—they don't earn delayed credits (see Figure 8)—and spousal benefits taken before FRA are reduced. An existing spouse as well as divorced spouses may claim benefits on a worker's record if they qualify.

Figure 7: Qualifying for Spousal Benefits

Spouses currently married	Divorced spouses
• Individuals must be married for at least one year. • Both must be at least age 62 (or spouse must be caring for a child under age 16 or over 16 and disabled before age 22). • The spouse (whose benefits are being collected upon) must have filed for benefits.	• Must have been married at least 10 years, and in some cases divorced at least 2 years. • Both ex-spouses must be at least age 62 (or caring for a child under age 16 or over 16 and disabled before age 22). • Ex-spouse filing for spousal benefits cannot be remarried. • Covered worker doesn't need to have filed for benefits and can be remarried.

Figure 8: How Spousal Benefits Are Determined**

If spouse doesn't qualify for their own benefits (or doesn't choose to elect them at FRA)	If spouse qualifies for their own benefits, their benefits are less than spousal, and they elect before reaching FRA
• Spousal = 50% of covered worker's benefit at FRA (reduced if elected early).	• Spousal = individual benefit + adjustment up to 50% of spousal FRA benefit (reduced if elected early).

*Certain spousal benefit strategies have been affected by the Bipartisan Budget Act of 2015.

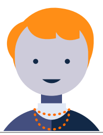
**Before an individual can claim a spousal benefit, their spouse must file for benefits. In the case of an ex-spouse (if divorced for two years) then they only need to be age 62 or older.

Strategies for Optimizing Social Security

Two couples, many options

Using two fictional married couples, Sam and Ann and Ted and Alice, whose individual benefits are outlined in Figure 9, we illustrate how spousal and other strategies can be employed.

Figure 9: Two Scenarios of Spousal Benefits

Example: Sam & Ann	Age 62 benefit amount	Age 66 (FRA) benefit amount	Age 70 benefit amount
 **Ann**	$675	$900	$1,188
 **Sam**	$1,553	$2,071	$2,733
Ann's Spousal Benefit*	$724	$1,035	$1,035

*Assumes Sam has filed for retirement benefits.

Example: Ted & Alice	Age 62 benefit amount	Age 66 (FRA) benefit amount	Age 70 benefit amount
 **Ted**	$1,014	$1,353	$1,785
 **Alice**	$1,707	$2,277	$3,005
Ted's Spousal Benefit*	$796	$1,138	$1,138

*Assumes Alice has filed for retirement benefits.

If born after January 1, 1954 recipients are only eligible for their highest personal benefit.

Strategy 1—Claiming Spousal Benefits

Figures 10 and 11 illustrate how much Ann and Ted could expect to receive from their spousal benefits once Sam and Alice have elected their own benefits. However, if Ann or Ted elects early, their benefits will be permanently reduced (whether they elect spousal or their own).

Figure 10: Determining Ann's Benefit*

	If Ann elects at 62	If Ann elects at FRA
How her benefits are determined	Ann's individual benefit ($675) will be compared to her spousal benefit ($724), both reduced for early election, and the amount paid will be the higher of the two. In this case, the spousal benefit.	Ann can elect either her individual benefit ($900) OR her spousal benefit ($1,035). In this instance, it may make sense to select the higher spousal benefit.
What this means to Ann	Ann will receive her own benefit and then an adjustment will bring her to the spousal benefit amount.	Ann can choose to elect her spousal benefit and let her own individual benefit continue to grow (a strategy covered later called "Claim Now, Claim More Later").

*Assumes Ann was born prior to January 2, 1954 and Sam has filed for retirement benefits.

Figure 11: Determining Ted's Benefit*

	If Ted elects at 62	If Ted elects at FRA
How his benefits are determined	Ted's individual benefit ($1,014) will be compared to his spousal benefit ($796), both reduced for early election, and the higher amount will be paid. In this case, his individual benefit.	Ted can elect either his individual benefit ($1,353) OR his spousal benefit ($1,138). In this instance, it may make sense to select the spousal benefit even though it is lower.
What this means to Ted	Ted's individual benefit amount will be compared to his spousal benefit and he will receive the higher amount (individual in his case), which will be paid automatically.	While it may appear that Ted should choose his own benefit (because it is higher), it may be beneficial for him to consider the long-term impact of Claim Now, Claim More Later.

*Assumes Ted was born prior to January 2, 1954 and Alice has filed for retirement benefits.

Strategy 2—Claim Now, Claim More Later*

Originally, when reviewing Figures 9 and 11, it doesn't appear to be in Ted's best interest to claim spousal benefits. And it certainly didn't seem to make sense for Alice to claim spousal as Ted's individual benefit is much lower than her own. However, there's a strategy in which it may make sense—and may be to their benefit.

In Figure 12, we assume Alice and Ted are both 66 (FRA). He has elected his individual benefit, and Alice has elected her spousal benefit. Consider the results:

- Their combined Social Security income at 66 is $2,029 per month.
- Since they're both FRA, they can continue working without any earnings caps.
- Once Alice turns 70, she can elect her individual benefit at the delayed rate of $3,005 and increase their monthly income to $4,358. This is nearly $728 more per month than if they both elected individual benefits at FRA ($3,630).
- A spousal benefit adjustment may apply once the higher benefit spouse elects their individual retirement benefit.

Always consider the impact to your withdrawal strategy from personal savings when electing this strategy.

If a worker elects Social Security before FRA, their individual and spousal benefits will be looked at together and the higher will be paid. However, if the individual waits until FRA, they can claim spousal, delay their own individual benefits, and continue earning delayed credits.

Figure 12: Alice Claims Now and Claims More Later**

	Ted	Alice	Total monthly income
Option A – Step 1 Ted elects individual benefits at FRA, Alice elects spousal at FRA	$1,353	$676	**$2,029**
Option A – Step 2 Ted elects individual benefits at FRA, Alice elects individual benefits at age 70	$1,353	$3,005	**$4,358**
Option B Ted and Alice elect individual benefits at FRA	$1,353	$2,277	**$3,630**

*Claim Now, Claim More Later strategy has been affected by the Bipartisan Budget Act of 2015. See page 14 for details.

**Does not assume annual COLA.

Strategy 3—Do-Over

Social Security has a provision commonly known as the "Do-Over" provision that enables an individual to change their claiming decision because of a change in circumstances. Utilizing this provision could benefit single or married people in various circumstances. For example, they can:

1. Repay the benefits issued (including any family benefits).
2. Claim a refund on any taxes paid.
3. Refile for a higher benefit.

The Do-Over provision requirements include:

- A withdrawal decision must be made within 12 months of the original election.
- Each individual is only granted one withdrawal per lifetime.

Visit **ssa.gov** for more information.

Do-Over Provision

Major Changes Due to the Bipartisan Budget Act of 2015

Elimination of the Social Security Claim and Suspend strategy

This strategy allowed one spouse to file and suspend their own benefits, helping them earn 8 percent delayed credits per year until age 70, while the other was able to receive a higher spousal benefit. Under the new law, it's no longer available for those who hadn't started the strategy within six months of the legislation being passed.

All Social Security recipients in this strategy up to the deadline were able to continue. The remaining individuals unable to start the strategy within six months of the legislation's passage weren't able to suspend a benefit and continue to pay out spousal benefits.

Elimination of the Social Security Claim Now, Claim More Later strategy

This strategy was also eliminated for those born January 2, 1954, or later—effectively for those under the age of 62 prior to that date.

Going forward, the only way individuals can receive a spousal benefit is if the benefit is greater than their own Social Security benefit and their spouse receives Social Security benefits.

Increased oversight of disability applications

Applications for Social Security disability benefits are subject to increased physician oversight. At the same time, restrictions on working while on disability are relaxed. This allows for disability recipients to retain benefits while working and enables the disability trust fund to receive additional funding from payroll taxes.

Other Considerations

Survivor benefits

In discussing and planning these various strategies with married or divorced couples, it may be prudent to consider that should one spouse die, the surviving spouse (and potentially a surviving ex-spouse) may be entitled to widow or widower benefits. As Figure 13 demonstrates, unlike spousal benefits, survivors can benefit from delayed credits. If Sam elects at age 70 and then dies, Ann will receive his entire individual benefit, at the delayed rate of \$2,733 per month, as long as she is at least FRA before she collects.

Figure 13: Sam Passes Away

	If Sam elects at age 62	If Sam elects at FRA	If Sam elects at age 70
Sam's retirement individual benefit	\$1,553	\$2,071	\$2,733
Ann's spousal retirement benefit (if she elects at FRA)	\$1,035	\$1,035	\$1,035
Survivor benefit (assuming Ann is at least FRA)	\$1,562*	\$2,071	\$2,733

* If the deceased elected benefits early, the starting point for the survivor benefits can only be reduced to 82.5 percent of what the deceased would have received at FRA. Of course, they can be reduced further if the survivor elects early to a minimum of 71.5 percent of Sam's FRA.

Assuming no COLA adjustment.

Are they already entitled to survivor benefits?

Interestingly, as a widow, Ann can claim survivor benefits as early as age 60 if Sam's death precedes Ann's. As Figure 14 shows, although the survivor benefits will be reduced by 28.5 percent from Sam's FRA benefit if she elects them this early, it can be worth her while. Consider that at age 60, she's not entitled to her own retirement benefits.

- She can, therefore, collect her reduced survivor benefits and allow her own individual benefit to earn delayed credits.
- Ann has the option of electing her own retirement benefits when she's eligible for them—which may make sense if they grow to be greater than her survivor benefits.
- In Ann's particular case, this won't happen, but with two high earners, the survivor's delayed individual benefits could be higher than their widow/widower benefits.

A widow or widower is eligible for survivor benefits at age 60. Once the individual turns 62, they're eligible for their own retirement benefit.

While no one likes to consider what will happen when a spouse dies, it's inevitable and may be worth considering in the longevity and Social Security election discussion. It's important to note, however, that survivor benefits replace the individual or spousal benefit for the widow or widower. They don't receive both.

If a widow or widower remarries after age 60, they won't lose their benefit.

Figure 14: How Survivor Benefits Are Determined

If survivor elects at age 60	If survivor elects at 62, FRA, or later
• Deceased spouse's actual benefit reduced.	• The greater of deceased spouse's actual benefit (reduced if deceased or widower elects early) or survivor's own individual retirement benefit.

Taxes and Social Security

Social Security benefits may be included for Federal tax purposes. In order to determine what amount may be included as income, one should consider the adjusted gross income, then add in tax-exempt interest and one-half of the Social Security benefit. This is sometimes referred to as the “provisional income” (see Figure 15).

Based on tax filing status and the provisional income number, Figure 16 shows what the Federal tax liability might be on Social Security benefits. It's important to consider any potential state and local income taxes as well.

Of course, individuals should consult a tax professional for further information.

Figure 15: Formula for Provisional Income

Adjusted Gross Income + Tax-exempt Interest + 50% of Social Security Benefits = **Provisional Income**

Figure 16: Taxes on Social Security

Filing Single		**Married Filing Jointly**	
Provisional Income	Benefits Subject to Tax	Provisional Income	Benefits Subject to Tax
Under $25,000	0%	Under $32,000	0%
$25,000 – $34,000	**Up to 50% is taxable**	**$32,000 – $44,000**	**Up to 50% is taxable**
Over $34,000	Up to 85% is taxable	Over $44,000	Up to 85% is taxable

Source: Social Security Administration, 2014.

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