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Trade In Your Social Security Check

by

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Millions of retired Americans could substantially raise their living standards throughout retirement by sending checks for tens of thousands of dollars to the Social Security Administration. That's right, to the government.

At least that's the conclusion of Boston University Professor of Economics Laurence J. Kotlikoff, who began evaluating this strategy after reading an article in Forbes that noted an obscure and surprising provision of the Social Security law.

Incredibly, a recipient can "undo" his decision to take Social Security retirement benefits early simply by paying back--without any interest or inflation adjustment--the benefits he's received. He can then re-apply for Social Security and claim the bigger monthly checks paid to those who wait until an older age to claim benefits.

Does this really pay off? Yes, if you compare the Social Security ploy with what you'd have to pay an insurance company for a similar annuity.

Kotlikoff provides this example: A couple, now both 70, claimed Social Security retirement benefits at 62, as more than half of Americans do. They now collect $11,556 each a year. If they had waited until 70 to claim benefits, they would be entitled to $20,000 each a year--even though they didn't earn more wages between the ages of 62 and 70.

The couple fills out Social Security's form 521, "Request for Withdrawal of Application", and pays back $79,305 each in benefits. They then reapply--and begin collecting $20,000 a year each. In effect, they've each bought an extra $8,444 a year in inflation-adjusted annuity. The cheapest commercial annuity would cost them 40% more, Kotlikoff calculates.

Still, many couples might gag at the thought of writing a check for $158,610 to Uncle Sam. What about leaving money to the kids? What if one of them keels over tomorrow?

Here's a potentially more palatable option: Have only one spouse trade in benefits. For $79,305, the couple gets an $8,444 joint life annuity. Joint life, because if the spouse who buys the higher benefit dies first, the survivor gets to take the deceased spouse's bigger Social Security check instead of his or her own smaller one. In other words, you get the survivor's benefit for free. Buying this annuity from a commercial insurer would cost 80% more, Kotlikoff says.

"If anybody is going to buy an annuity, they should buy it from Social Security first," he concludes.

Unfortunately, part of what you save by buying your annuity from Social Security, you could have to pay back to the government in the form of taxes. Depending on your income, up to 85% of your Social Security benefits is subject to federal income taxes. If you buy an immediate commercial annuity with after-tax dollars, a large part of what you get back is considered a nontaxable return of principal. A 70-year-old couple buying a joint life annuity would typically be able to exclude 64% of the annuity payment from federal taxable income.

So Kotlikoff also evaluated the Social Security trade-in strategy using ESPlanner, financial planning software he co-developed, that aims to maximize and smooth consumption over a lifetime while taking taxes into account. Say our 70-year-old couple has no pension, no Individual Retirement Accounts, and $400,000 in taxable investments. They invest conservatively and want to make sure that their assets last until they're both 100.

If they both trade in for higher Social Security benefits, they will be able to spend 25% more a year; if they both buy commercial annuities paying an extra $8,444 a year, their living standard goes up only 12%, the program shows. That 25% increase in living standards, Kotlikoff notes, is the equivalent of the couple getting a $200,000 inheritance.

If the same couple also has $400,000 in pretax IRA accounts, Social Security is still a better buy than a commercial annuity, but its advantage is smaller. That's because mandatory withdrawals from their IRAs raise their gross income and make more of their Social Security benefits taxable. They'll get a 14% living standard boost from buying bigger checks from Social Security, versus an 11% increase if they buy commercial annuities.

But even for this higher-income couple, Social Security is a big winner over a commercial annuity if they (reasonably) bet that that only one of them will live to be very, very old and only one spouse trades up to a bigger Social Security check. After the first spouse dies, the survivor has a 17% higher living standard than if the couple had done nothing. By contrast, buying an expensive commercial joint life annuity would raise the survivor's living standard by only 6%.

Is repaying Social Security to gain higher benefits legal? Yep, says Mark Lassiter, a spokesman for the Social Security Administration. "We don't consider it naughty," he says. Form 521 asks for your reason for withdrawing your initial benefit application, but that's only so that Social Security employees can make sure the person filing the application understands what he's doing.

You can write that your reason is that it's better for you financially and the SSA won't nix your application, Lassiter says. About 100,000 folks file Form 521 each year, but the Social Security Administration doesn't tally the reasons they give. Some, no doubt, have simply decided not to quit working so soon.

Kotlikoff, for his part, is convinced millions of retirees in their late 60s and early 70s would benefit from trading in their benefits. Be aware that the return from trading in declines after 70. That's because Social Security benefits don't continue to grow past that age, and you'll have more years of previous benefits to repay.

This all raises the question of whether--assuming you don't actually need a Social Security check to live on at age 62--you should wait until 69 or 70 to claim a bigger Social Security check or file for benefits at 62, invest the money, repay the early benefits at 69 or 70, and then claim that bigger check.

Kotlikoff says the answer depends on many factors. Among them: a couple's other income, which will determine how much of those Social Security benefits they receive from 62 to 70 will be taxed, and at what rate.