Secure Income Options

Social Security VS Annuity

(Contributed by Justin Fundalinski, MBA)

As many of our clients and newsletter subscribers know, we are advocates of ensuring there is enough *secure income*[1] to fully cover a retiree's *required expenses*[2]. The reasoning behind this concept is that in a "worst-case" scenario in which a retiree's assets become depleted (due to overspending, poor market performance, extended longevity, etc.), they are able to maintain a reasonable standard of living that is maintained by the monthly income generated from there secure income sources. That is, with enough secure income a retiree can rely on the safety and security of their secure income sources just as they relied on the safety and security of their paycheck while they were in the working force. Unfortunately, generating enough secure income can be a difficult task and it requires hard decisions early on in retirement. Most often, one of the key recommendations that we make currently is to delay Social Security. Recently, we were asked to defend that recommendation against turning on Social Security income at Full Retirement Age (age 66 in this case) and supplementing it with annuity income to offset any income difference that an earlier Social Security claim would create. This month's article is an overview of this case and our defense!

The Options:

1. Claim Social Security at age 70 and begin collecting approximately $40,700 annually of inflation adjusted[3] income.
2. Claim Social Security at age 66 and begin collecting approximately $28,200 annually of inflation adjusted income. To offset the income gap from claiming early, approximately $8,700 annual inflation adjusted annuity income is purchased.[4]

The Primary Costs:

1. The cost of delaying Social Security in this case is the forgone income that could be generated from claiming Social Security early as well as the income generated from the annuity. The four years of lost income adds up to $147,400 (adjusted for inflation). **This $147,400 is the cost of delaying Social Security.**

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[1] Our definition of **Secure Income** is an income stream that (1) is predetermined and known; there is no ambiguity with how much income you will receive throughout your retirement; (2) your income can never be cut, it can only increase and (3) the income is not backed by your assets alone, it is backed by a third party

[2] A **Required Expenses** is an expense if you don't cover you will suffer an *economic, financial or medical* hardship. Required Expenses by their very definition are difficult to cut or reduce and must be fully covered until mortality with inflation adjusted guaranteed income.

[3] Note that we cannot predict what the inflation adjustments will be, but for the sake of this analysis we have assumed an average COLA (cost of living adjustment) of 2.5%

[4] You might be saying to yourself, "Now wait a minute - $28,200 plus $8,700 does not add up to $40,700." You are right and you are wrong! Remember that this income is being turned on at age 66 and is adjusted for inflation. Remember, we want this income to match the income that could be generated at age 70 from Social Security. Four years after this inflation adjusted Social Security and Annuity income is turned on it is combined income of about $40,700.

2. The cost of turning Social Security on early and purchasing the annuity is rather easy to calculate. It is the premium of the annuity. In this particular case a 66 year old Colorado female was quoted a premium of $188,500. **This $188,500 is the cost of turning on Social Security on early.**

When you look at the costs it seems like delaying Social Security is a clear winner as it is about $40,000 less expensive than purchasing an annuity. However, we recognize that this is a hard concept to follow so think about it like this; at age 66 this person could do one of two things:

1. They could take $147,000 (maybe a bit more to cover the inflation adjustments) and place it in a bank. Each month they can take out the amount that Social Security and the annuity would pay them. By age 70 this account would run out and their Social Security would turn on for the equivalent amounts being withdrawn.
2. Or, they could turn their Social Security on and take $188,500 and buy an annuity.

The end income result is essentially the same. The question is would you rather give $147,000 to the bank so you can pay yourself or give $188,500 to an annuity company?

The Secondary Costs:

Social Security is a unique income source when you consider how it is taxed. Unfortunately, to explain in detail how Social Security is taxed would take a lot more time than I can dedicate in this article. However, to sum it up, depending on the amount of Social Security and other income sources that one receives, the amount of Social Security income that actually gets taxed ranges between 0% and 85% (that is, a maximum of 85 cents out of every Social Security dollar received could be taxed at one's marginal income tax rate) . A better way to think about it is the more taxable income someone has on top of Social Security the more Social Security income that will be taxed.

What I am getting at here is, the more income that is generated by Social Security as opposed to other taxable sources the less taxes one will likely pay. So, depending on what type of asset is used to purchase an annuity can make a substantial tax impact. Considering we are dealing with retirees who generally have the majority of their assets in Traditional IRAs or 401(k)s any annuity income purchased with these "qualified" assets would be subject to ordinary income taxes and would likely increase the amount of Social Security that is taxable.

Another side effect that could occur if more income becomes subject to taxation is that an individual could be pushed into a higher marginal tax bracket. Depending on what tax bracket they are in this could not only cause taxes on income to be higher, but is could also cause taxes on capital gains to increase.

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The Tertiary Costs:

The fact is that retirement is an emotional hurdle. We get it! Some people just feel better once their secure income is turned on and they are receiving a check every month for the rest of their life. Our only stance on the emotional cost of waiting longer to turn Social Security on is this: It's the retiree's choice in the end, our job is only to explain the financial costs of the different options out there. We are not in the business of telling retiree's how to feel.

A key takeaway from this article is that not all retiree's secure income needs are the same so this is not an overarching discussion regarding the best way to file for Social Security. Also, Social Security income is not calculated based off of current interest rates like the annuity income is. In the future when interest rates are higher, it may very well make more sense to supplement Social Security income with annuity income as opposed to delaying Social Security. For more information regarding this topic please view our February 2015 article regarding this very topic.

A Fixed Annuity is a long-term financial product designed largely for asset accumulation and retirement needs. Fixed Annuities generally contain fees and charges which include, but are not limited to, surrender charges, administrative fees and for optional contract riders and benefits. Withdrawals and death benefits are subject to income tax. If withdrawals and other distributions are received prior to age 59 ½, a 10% penalty may apply. Fixed Annuities typically carry surrender charges for several years that may be assessed against withdrawals. Certain Fixed Annuity product features, offered by some Fixed Annuity companies, such as stepped up death benefit, a bonus credit and a guaranteed minimum income benefit, carry added fees. If you are investing in a Fixed Annuity through a tax-advantaged plan such as an IRA, you will get no added tax advantage. Under these circumstances you should only consider buying a Fixed Annuity if it makes sense because of the Fixed Annuities other features, such as lifetime income payments and death benefit protection. All guarantees of a Fixed Annuity are backed by the claims paying ability of the issuing insurer.