RETIREMENT TAX

Delaying your Social Security has rarely been this profitable

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Inflation adjustments compound the size of Social Security checks, so waiting to take the benefit is usually worth it.

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It's no secret that delaying the start of Social Security benefits typically means you'll get more money in retirement. And waiting just got even more worthwhile thanks to the program's big cost-of-living adjustment set for next year.

Here's why: Even if you don't collect benefits, the COLA adjustment — 8.7% for 2023 — still gets factored into the amount you're eligible to receive starting at age 62. And it gets compounded, so each year you hold off on collecting until full retirement age (somewhere between 66 and 67 depending on when you were born) or beyond will make your eventual payout even juicier. The benefit increase stops when you reach age 70.

"COLAs magnify the disparity between early and late claiming," Elaine Floyd, a certified financial planner and author of Savvy Social Security Planning for Boomers, wrote in 2013 when the COLA was just 1.5%. "We can assume that all Social Security recipients celebrate when a generous COLA is announced. But some recipients celebrate more than others."

Figuring out how to maximize Social Security is vital considering it's a benefit that lasts for the duration of a recipient's life and is adjusted for inflation. The same can't be said for most, if any, other sources of income. About half of Americans 65 or older rely on Social Security for at least 50% of their household income. (For about a quarter of those 65 and over, it's at least 90% of their income.)

To understand how much a retiree stands to gain from waiting, it's helpful to lay out how benefits are calculated. The Social Security Administration takes into account a worker's highest-earning 35 years and adjusts those amounts for inflation. That provides a starting point for what an average monthly payout may be.

Next, a formula is applied to calculate what the benefit would be if collected at full retirement age. If someone starts collecting as soon as she's eligible at 62, she could see a reduction of as much as 30% in what's known as the primary insurance amount.

Any COLA adjustment gets added onto that primary insurance amount each year and compounds. And every month beyond the full retirement age up until 70 a retiree waits to collect translates into an additional credit applied to that higher primary insurance amount.

Let's say a 64-year-old retiree is eligible for a primary insurance amount of $3,000 per month at full retirement age. If she didn't collect last year, when the COLA was 5.9%, her benefits would have been adjusted to $3,177. The amount will get bumped up to $3,453 next year (with the latest COLA increase being applied to the higher inflation-adjusted amount). COLAs keep getting added the more years she waits; any delayed credits for not collecting benefits from full retirement age until age 70 are then applied on top of that amount. If she delays her benefits until age 70, then her monthly benefit (excluding any COLAs beyond next year) will be $4,374.

Inflation adjustments to tax brackets mean many Americans will owe less money to the IRS. But persistent inflation may erode the boost.

The other benefit of delaying Social Security, especially with a bigger COLA, is the tax savings. Yes, many recipients have to pay taxes on Social Security income. And those who have other sources of retirement income, like 401(k) or IRA accounts, may see as much as 85% of their Social Security benefits subject to taxes. But holding off on collecting benefits and ultimately getting a bigger lifetime payout means those retirees won't have to tap their personal accounts for as much money; in turn, the taxable portion of Social Security benefits drops.

In an example from Bill Reichenstein, the head of research at Social Security Solutions, a retiree who delays claiming until 70 can cut the taxable portion of her Social Security benefits from 85% to just 19.5% — and see a tax bill of less than one-fifth of what it would be if she began collecting at age 66.

Still, there are some people for whom delaying benefits won't make sense, despite a heftier payout and lower tax bill. Those who have a terminal illness or shorter life expectancy may want to collect what they can as soon as they can (unless they're married and concerned about a spouse's benefits).

Also, consider the breakeven — the age a retiree has to achieve to make delaying benefits worthwhile. Typically, you have to live to 82 ½ to reap the benefits of holding off until age 70, according to Reichenstein. Those who die before then would have been better off taking benefits at full retirement age. It's an awkward and difficult calculation to make though, and really, who knows?

Others may argue that Social Security is on shaky footing, so not collecting benefits as soon as possible is foolish. Sure, the latest projections say the trust fund won't be able to pay full benefits starting in 2035, but if the past is any guide, any changes to shore up finances would likely focus on changing rules for younger people with years left to work, rather than for soon-to-be retirees on the cusp of receiving benefits.

So if you're in your sixties and able to wait, just bide your time.

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