LIVING WELL IN RETIREMENT

Back-to-Work Benefits Squeeze

If you lose money to the dreaded Social Security earnings test now, you'll recoup it later on.

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It sounds like a cruel joke. After a lifetime in the workforce, you call it quits at 62 to claim your Social Security benefits and begin a long and satisfying retirement.

Then, the worst economic calamity since the Great Depression hits with the vengeance of Hurricane Katrina, decimating your nest egg and depleting the value of your home. Faced with the painful reality that you must go back to work, you count yourself lucky to find a job at a time of stubbornly high unemployment.

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And your reward? The federal government suspends your Social Security benefits.

Say hello to the confusing and controversial Social Security earnings test. This provision of the law says sure, you can claim your benefits as early as age 62, but you can't necessarily keep the cash if you work prior to reaching your normal retirement age (66 for workers born in 1943 through 1954).

The earnings test cost a quarter of a million working Social Security beneficiaries $757 million in forfeited benefits in just the first seven months of 2009, according to a ballpark estimate Social Security officials made for Kiplinger's. That's up 14% from the $666 million lost in the same period in 2008.

No one knows how much of the increase is a result of retirees being forced by deteriorating finances to go back to work. But it's clear that anyone who claims Social Security benefits early—or who's thinking about it—needs to understand exactly what's going on here.

How the earnings test works.

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If you apply for Social Security benefits early, you'll be asked whether you plan to keep working—and, if so, how much you expect to make—to determine whether you'll be stung by the earnings test.

For 2010, the test applies if you make more than $14,160. And for every $2 you earn over that limit, you'll lose $1 of benefits. Suppose you claim benefits at age 62 and your monthly benefit is $1,500 (and you estimate that you'll earn $30,000 during the year). Because $30,000 is $15,840 over the limit, you would lose half of the excess, or $7,920, in benefits.

The Social Security Administration (SSA) doesn't trim each check by a proportional amount. Your benefits are withheld completely until the squeeze is satisfied. In this example, you'd get no benefits for five months (covering $7,500 of the lost benefits), and your benefit in the sixth month would be $1,500 minus the final $420 claimed by the earnings test, or just $1,080.

In the year you first claim benefits, the test basically lets you ignore money you made before you applied and squeezes benefits based on monthly earnings for the rest of the year.

In the year you reach normal retirement age, a more lenient earnings test applies: You lose $1 for every $3 in earnings over $37,680 before your birthday. Starting in the month you reach normal retirement age, the earnings test no longer threatens your livelihood. You can earn as much as you want without losing a dime in benefits.

Note this: For purposes of the earnings test, only wages from a job or self-employment income count. Investment earnings, pension benefits, money drawn from an IRA or 401(k), and even lottery winnings do not.

Not the honor system.

Although you will be asked to estimate your earnings, your projection isn't the final word. When you file your tax return, the IRS lets the SSA know exactly how much wage and self-employment earnings you report. That figure is compared with your estimate, and the government reconciles the books by either sending you a check—if your estimate of earnings was too high and the earnings test clawed back too much of your benefits—or dunning you for a balance due.

This final point is particularly important if you unexpectedly return to work while you're subject to the earnings test. You should let the SSA know of your change in circumstances as soon as possible so that your benefits can be trimmed if you run afoul of the earnings test. Failing to do so could come back to haunt you later. If the tax return you file shows earnings that should have triggered reduced benefits, you'll be asked to pay back the excess in a lump sum or see future benefits reduced.

A silver lining in the earnings test.

Although the earnings test is often derided as an unconscionable 50% surtax—because $2 in earnings can cost you $1 in benefits—it's not as evil as critics complain. Benefits lost to the test are not gone forever. Instead, the law is designed to ensure that you recover any forfeited amount via higher monthly benefits later.

Remember, if you claim benefits before your full retirement age—and 43% of men and 48% of women claim them as soon as they can, at age 62—your benefits will be permanently reduced. But for any month you lose benefits to the earnings test, the SSA will ratchet up future benefits.

Say you retire at 62, happy to accept the 25% haircut in benefits in exchange for collecting four years early. Then you have to go back to work and wind up forfeiting 12 months' worth of benefits.

Basically, when recalculating your benefits at your full retirement age, you'll be treated as though you claimed benefits just three years early, not four. So, instead of having your

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lifetime benefits reduced by 25%, in this example you'd suffer about a 20% reduction going forward.

And if your earnings during your period of forced re-employment are higher than one of the 35 years of earnings originally used by Social Security to compute your benefit, your monthly payments could rise even more.

Delayed Gratification

THE RETIREMENT AGE IS RISING

The age at which you can start collecting Social Security without suffering a lifetime reduction in benefits—or being threatened by the earnings test—continues to increase.

Birth Year	Age to qualify for full benefits	Cut in benefits if claimed at 62
1943–1954	66	25.00%
1955	66 and 2 months	25.83
1956	66 and 4 months	26.67
1957	66 and 6 months	27.50
1958	66 and 8 months	28.33
1959	66 and 10 months	29.17
1960	67	30.00

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