InvestmentNews

How Social Security benefits are calculated

Estimated benefits assume continued earnings through full retirement age

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By Mary Beth Franklin

I received an interesting question from a reader the other day regarding how Social Security benefits are calculated. He said that his wife, who is in her mid-30s, has an estimated Social Security benefit of about $2,600 per month at her full retirement of 67.

The reader noted that her estimated benefit is close to the maximum retirement benefit of $2,639 payable in 2016. That maximum benefit amount does not include any delayed retirement credits that can boost benefits by an additional 8% per year between full retirement age and 70.

“She has 30+ years until her full retirement age, and it would appear that she will only gain $15 more (plus cost-of-living adjustments) if she continued to work,” the reader said via email. “I assume the projections she gets are based on what she has earned up to this point, and are not assuming she continues to work at the same salary,” he added. “Thirty-one years of future payments for a $15 monthly increase hardly seems worth it. At what point does it make sense to no longer work?”

That would certainly be a bad deal if future tax contributions didn't lead to a higher retirement benefit. But that's not how Social Security benefits are calculated.

“Your wife's estimated benefits are based on the assumption that she keeps working and earning at current levels through her full retirement age,” I responded. “If your wife works fewer than 35 years, the missing years will be assigned zeroes when calculating her average lifetime earnings, resulting in a lower benefit.”

Actual earnings are indexed to account for changes in average wages since the year the earnings were received. Social Security calculates your average indexed monthly earnings during the 35 years in which you earned the most and then applies a formula to these earnings to arrive at your basic benefit or primary insurance amount (PIA), which is how much you would receive at your full retirement age. If you want to get your geek on, you can find the PIA formula here.

You can choose begin to receive Social Security benefits as early as age 62, but your benefits would be reduced by 25% or more depending on your full retirement age. Or, you could delay claiming your benefits up until age 70 to receive the maximum amount.

You are eligible for cost-of-living benefit increases starting with the year you become age 62 even if you don't get benefits until your full retirement age or later. Cost-of-living increases are added to your benefit beginning with the year you reach 62 and up to the year you start receiving benefits. In the future, your benefit will increase in any year there is a cost-of-living adjustment.

Separately, another adviser asked if benefits would increase for a client who is 66, retired and collecting Social Security if that individual returned to work.

Possibly. Once you reach full retirement age, there are no earnings restrictions so benefits will not be reduced no matter how much you earn. That is not the case for beneficiaries who claim Social Security before full retirement age and who continue to work. In 2016, they lose $1 in benefits for every $2 earned over $15,720 if they are under 66 the entire year. In the year they turn 66 in the months leading up to their birthday, a higher earnings limit applies: They forfeit $1 in benefits for every $3 earned over $41,880. The earnings cap disappears at 66.

Social Security reviews the records for all beneficiaries who work. If your latest year of earnings turns out to be one of your 35 highest earnings years, Social Security will automatically recalculate your benefit and pay you any increase due. Benefits are paid in December of the following year. For example, in December 2016, you should get an increase for your 2015 earnings if those earnings raised your benefit. The increase would be retroactive to January 2016.