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Why Soldiers Should Choose High-3 Over Redux

Introduction

The Army's Redux retirement plan was a mistake from the start, and it risked irreparable harm to the soldiers and families for whom it was designed. Soldiers responded convincingly, choosing to leave the Army rather than continue their military service. In its attempt to reduce the damage inflicted by Redux, the Army now offers a compromise solution. Unfortunately, the Army has fallen short of giving soldiers definitive guidance about which retirement plan is best for them. Beginning March 1, an alarmingly high percentage of the first to choose between the High-3[a] and Redux[b] retirement plans chose Redux, in spite of its reduced benefits. This article seeks to provide the information, based on quantitative analysis, that will help soldiers choose the retirement plan that is best for them.

A Brief History

In its original form, Redux provided soldiers who entered active military service after August 1, 1986 and retired after 20 years with less retirement pay than its immediate predecessor, High-3, when compared using today's dollars. Soldiers responded convincingly by leaving the Army.

To stem the tide of soldiers leaving, in 2000[c] the Army began offering an incentive to choose Redux instead of High-3. In exchange for agreeing to serve 20 years, the Army is tempting soldiers with the Career Status Bonus (CSB) option of $30,000 to be paid in a lump sum on the soldiers' 15th anniversary of service. Of course, Redux provides smaller retirement checks, and with certain exceptions the CSB would be considered taxable income, further reducing the value of Redux.

Recognizing the tax consequences, effective April 1 of this year, soldiers who choose Redux instead of the High-3 retirement plan can also choose to take the CSB in equal annual payments over a period of up to five years, which will allow them to defer taxes on the entire bonus if they deposit it into a qualified retirement plan such as the Thrift Savings Plan.

Comparison with High-3

In the vast majority of cases, the High-3 retirement plan will provide service members more retirement benefits than the Redux retirement plan, even after including the $30,000 Career Status Bonus (CSB). The Army has provided a retirement calculator for comparing the two retirement systems. However, this tool is currently inadequate to analyze the two retirement options. First, the calculator at http://militarypay.dtic.mil fails to account for new legislation to

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[a] Choosing High-3 provides members lifetime monthly payments equal to 50% of the average of the highest three years of monthly basic pay. Each year beyond 20 years of service increases the percentage by 2.5%, up to a maximum of 75%. Annual cost of living increases are equal to the Consumer Price Index (CPI).

[b] Choosing Redux provides members lifetime monthly payments equal to 40% of the average of the highest three years of monthly basic pay, and a $30,000 cash incentive paid on the soldier's 15th anniversary of service. Each year beyond 20 years of service increases the percentage by 3.5%, up to a maximum of 75%. Annual cost of living increases under Redux are equal to the CPI minus 1%, with a one-time increase at age 62 to make monthly payment equal to the payment under High-3. Subsequent cost of living increases for Redux would again be equal to the CPI minus 1%.

[c] FY2000 Defense Authorization Act.

take the CSB in multiple annual payments and gain the benefit of deferring income taxes until retirement. Second, this retirement calculator does not make it clear that a service member must earn unreasonably high rates of return on his/her invested CSB bonus in order to make up for lost future cash flows under the Redux plan. Essentially the Redux option is providing the service member with a large sum of money now in return for receiving lower retirement checks in the future.

Like the Army's retirement calculator, we used a technique called Net Present Value (NPV) analysis to compare the cash flows under the two retirement systems. In order to conduct NPV analysis, one must make certain assumptions that describe the typical soldier who retires from the Army. The assumptions used for this analysis are listed below the chart. The most significant assumption is how the money will be received and spent by the service member. Because it provides the greatest tax advantage and results in the highest value if invested until retirement at age 62, we assume soldiers who choose Redux will take the CSB in three equal annual payments of $10,000 each. This allows soldiers to invest the money in a qualified tax-deferred retirement plan as soon as possible, without exceeding the federal limit that can be sheltered from taxes each year. We further assume that the soldier will use his or her entire retirement fund for additional income between the ages of 62 (retirement age) and 70 (approximate age of death[d]).

The chart below indicates some typical ranks at which a soldier with 20 years of service might retire. There are two key points to take from this chart. First, assuming that the Career Status Bonus, as well as other invested funds, can earn a rate of return of 10% (typical annualized stock market return over the past 100 years), the chart shows the value of each of the retirement plans in today's dollars. Second, the chart shows the annualized rate of return on invested funds that he/she would have to achieve in order to make the Redux option more attractive than the High-3 option. In any situation where a soldier retires at 20 years of service, regardless of rank, the service member must be able to achieve rates of return that well exceed long-term stock market returns. The required rate of return becomes higher and more difficult to achieve for soldiers retiring at higher ranks because the 10% difference in retirement pay is a larger number. The same $30,000 bonus applies regardless of rank.

Rank[1]	Estimated 100% Base Pay (Pre-Tax) at Retirement[2]	Retirement Plan	Initial Pre-Tax Retired Pay[3]	Initial Post-Tax Retired Pay[4]	Value of retirement in today's $ with a 10% rate of return on investments[5]	Required rate of return on 100% invested bonus to make Redux NPV better than High-3 NPV[5]
E-6	36,671	Redux	14,668	10,575	108,020	13%
		High-3	18,336	13,201	116,456	
E-7	41,618	Redux	16,647	11,986	120,422	14%
		High-3	20,809	14,982	132,167	
E-8	46,250	Redux	18,500	13,320	131,632	15%
		High-3	23,125	16,650	146,877	
WO-3	53,287	Redux	21,315	15,347	147,694	16%
		High-3	26,643	19,183	166,030	
O-5	82,809	Redux	33,123	23,848	215,833	21%
		High-3	41,404	29,811	252,377	

[d] Commissioner's 1980 Standard Ordinary Mortality Table estimates average age of death is 73.24 years for male born in 1970 (approximate year of birth for many soldiers currently contemplating High-3 vs. Redux). We chose to be conservative by estimating death at age 70 (High-3 becomes even more beneficial if you live longer).

1 Selected most common NCO ,Warrant Officer, and Officer ranks at retirement at 20 years of service (retirement ages of 38, 40, and 42 for NCOs, Warrant Officers, and Officers respectively)
2 Based upon the 2002 pay chart with 3.5% growth annually—weighted average of the last three years of service (when retiring after 20 years, that is two years of Over 18 and 1 year of Over 16 years)
3 Redux based upon 40% at 20 years (One-time catch up to High-3 at age 62). High-3 based upon 50% at 20 years.
4 Assumes 28% combined Federal/State taxes
5 Assumes the most tax- and NPV-efficient method to take the bonus (i.e. 3 installments of $10,000 each into the Thrift Savings Plan to get the money invested as soon as possible and defer all taxes until drawing a retirement annuity). Also, this NPV assumes death at age 70 (average life expectancy of a male born in 1999); draw an annuity from the TSP invested bonus on 1 January each year for ages 62 through 70. Note that the High-3 becomes even more favorable each year past age 70 due to annual COLA adjustments (COLA increases for High-3 are equal to Consumer Price Index increase, however Redux adjustment is only COLA minus 1%)

Exceptions to Choosing High-3

Clearly, not all soldiers fit a typical profile like those represented in the chart, so it is important to account for differences between soldiers that might make Redux more – or less – attractive. At higher retirement ranks, the difference in retirement pay between High-3 and Redux becomes larger, making the High-3 retirement plan even more attractive. If the soldier lives beyond age 70, the High-3 retirement plan becomes more attractive because the soldier receives more retirement pay for a longer period of time. Serving beyond 20 years in the military can make the Redux retirement plan more desirable, because Redux benefits grow at 3.5% of base pay per year beyond 20 years where High-3 benefits grow at only 2.5% of base bay per year beyond 20 years. At 30 years of service, both plans reach a level where retirement pay is 75% of base pay. In that case, the principal negative aspect of Redux is that it has a lower annual cost of living increase than the High-3. However, it may be difficult for a soldier to determine at the 15 year mark of his/her career whether he/she will be willing or even able to serve beyond 20 years.

Conclusions

Overall, the High-3 retirement plan is better for the vast majority of soldiers. The Army's own website at http://militarypay.dtic.mil allows soldiers to review typical retirement situations. For some, the Career Status Bonus provides a strong incentive to choose Redux and accept lower retirement pay. Unfortunately, choosing Redux can be a costly mistake. For example, consider a Sergeant First Class who retires after 20 years of service at age 38. When compared to Redux, the retirement calculator shows that if a soldier who chooses High-3 invests the additional retirement pay (10%) in a retirement account each month, at age 55 the soldier will have more money saved than the CSB would be worth at the same age[e]. In addition, the retiree receives the extra 10% retirement pay for another 7 years, until age 62, when the retirement pay under Redux is adjusted for the one-time catch-up with High-3. After that the High-3 retiree still has the benefit of full inflation protection, as his annual pay increases by the full Consumer Price Index growth rate, while Redux grows at the CPI minus one percent. Every soldier must carefully evaluate his or her particular situation and priorities. Most will find that High-3 provides better retirement pay, and they should not be lured by the trappings of the Career Status Bonus.

"The views expressed in this article are those of the authors and do not reflect the official policy or position of the United States Military Academy, the Department of the Army, or the Department of Defense or U.S. Government."

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[e] This assumes a 3.5% of inflation, a 28% combined state/federal tax rate, and 10% returns on all investments.