Choosing Between the High-Three and the Redux Military Retirement Programs: Thrift Savings Plan Participation a Valuable Option

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Introduction

Service members who entered service after 1 August 1986 may select between two retirement plans[1] commonly called "High-Three" and "Redux."[2] The primary differences between the two retirement programs are a "career-status" bonus and pay differentials.[3] When comparing the two programs, members should determine which program yields the greatest future economic value. The key factor is a member's plans for the Redux career status bonus. Future economic values differ significantly depending on whether and how a member invests his bonus. Values also differ greatly for enlisted and officer members.[4] In addition, the availability of the Thrift Savings Plan (TSP)[5] affects future values. If Congress fully implements the TSP,[6] members who plan to retire under Redux could invest significant portions of their bonuses into their TSP accounts tax deferred..[7] This article discusses these factors and compares the future economic values of both retirement plans.

Which Program Produces Greater Future Economic Value: High-Three or Redux?

In general, this article argues that Redux retirees will reap the greatest future economic values. The discussion below

1. In response to concerns regarding recruiting and retention, Congress modified the military retirement system in 1999. The Defense Authorization Act for fiscal year 2000 provided a choice for members eligible for the Redux program. After fifteen years of military service, members can agree to serve an additional five-years, receive a $30,000 career-status bonus, and retire under Redux. Alternatively, members can continue to serve and retire under High-Three. National Defense Authorization Act of 2000, Pub. L. No. 106-65, § 642, 113 Stat. 512 (1999). Members who entered service after 8 September 1980, but before 1 August 1986, are limited to the High-Three retirement program. *See infra* appendix entitled *Retirement Programs Available to Active Duty Service Members*.

2. The retirement program commonly termed Redux was created when Congress made major changes to the military retirement program in the Military Retirement Reform Act (MRRA) of 1986. Supposedly troops bitterly called the new retirement program "Redux." Sydney J. Freedberg Jr., *Smart Salute*, NAT'L J., Jan. 30, 1999, at 265. Legislators apparently did not use the term. A search of the legislative history surrounding the passage of MRRA failed to find the use of the word. The term probably is not an acronym, although it often appears in capital letters. Further, the meaning of the word, redux, seemingly did not to apply in 1986. Redux means to bring back or restore. THE COMPACT OXFORD ENGLISH DICTIONARY (2nd ed. 1991). The 1986 legislation reduced benefits, so perhaps troops misapplied the word. However, the term is appropriate under current legislation. The latest legislation allowing members to choose to return to the High-Three program makes the term Redux applicable to the choice of programs. Members can "restore" their benefits by choosing the High-Three program. Finally, Ms. Toni Hustead used the term "REDUX" on page 8 of an Office of the Actuary report entitled "Valuation of the Military Retirement System" (Sept. 8, 1987). She used the term as follows, "members first entering the Armed services on or after August 1, 1986, are subject to a reduction (REDUX) if they retire with less than 30 years of service." Interestingly, she seemed to have misapplied the word and used capital letters. Perhaps, the word was in common usage before Ms. Hustead caused the word to be used in print.

3. The $30,000 career status bonus received by Redux participants serves as a tradeoff for their future lower retirement payments. Another significant difference between the programs is the cost of living adjustments. *See infra* appendix entitled *Retirement Programs Available to Active Duty Service Members*.

4. To discern these generalizations, see ARMY LAW., Sept. 2000, at tbl. 1 (Redux Data), *at* http://www.jagcnet.army.mil/TJAGSA (Publications, 2000, September, Miscellaneous Administrative Information).

5. Congress created the Thrift Savings Plan (TSP) in 1986 for federal civilian employees to serve as a supplement for their retirement programs. The TSP, with its 401(k) like features, enhances opportunities to save for retirement and complements underlying retirement programs. Military members may be able to participate in the TSP in the future. *See infra* note 6. Retirement plans commonly called "401(k) plans" meet the requirements of section 401(k) of the Internal Revenue Code. These plans allow employees to choose to have their employers pay part of their compensation into a retirement fund. Often the employer matches an employee's contribution. Within limits, there is no tax liability on any contributions during the year the employee or employer contributed the funds. I.R.C. § 401(k) (1999).

6. Congress approved the provisions of the National Defense Authorization Act for fiscal year 2000, thereby authorizing service members to participate in the TSP. Specifically, the Act amended 37 U.S.C. § 211. The amendment expanded the definition of "member" to include members of uniformed services serving on active duty and members of the Ready Reserve. The Act also amended pertinent sections of 5 U.S.C. §§ 8401-79 to accommodate service members. National Defense Authorization Act of 2000, Pub. L. No. 106-65, § 661, 113 Stat. 512 (1999). Implementing the TSP depends upon "offsetting" legislation. The "offset" is for probable lost tax revenue due to the tax deferment aspect of the program. House and Senate members are nearing agreement on how to fund the program. Recent discussions have the legislators earmarking $980 million for military participation. Rick Maze, NAVY TIMES, *Military Good to go on Thrift Savings Plan: Lawmakers Come Through with $980M to Fund Service Members' Participation*, Apr. 24, 2000, at 18. For a detailed discussion of the TSP, see Major Vivian Shafer, *The New Thrift Savings Plan for the Miltary: Worth Consideration*, ARMY LAW., Sept. 2000, at 1.

7. For calendar year 2000, members could contribute up to $10,500. I.R.C. §§ 402(g).

amplifies this generality, and readers should consider carefully the author's underlying assumptions.[8] These assumptions may not be valid for individual service members. Moreover, service members are encouraged to use the Department of Defense (DOD) software, discussed below, when deciding which retirement plan works best for them.

Enlisted Service Members

If an enlisted service member invests a significant portion of his career status bonus, the Redux retirement plan will result in a greater future economic value than the High-Three plan. Suppose an enlisted Redux participant can afford to invest his entire career status bonus after he pays the appropriate income taxes. From the $30,000 bonus, suppose that he invests the maximum of $10,500 in the TSP.[9] He will achieve greater future economic value from the Redux retirement plan, regardless of when he withdraws his invested money. For instance, if the investment is withdrawn at age sixty-two, the Redux plan will yield $142,627 more than the High-Three plan. Upon withdrawal, if the Redux participant pays taxes[10] from his accumulated investments, he still will have greater assets than a comparable High-Three participant.[11]

If the enlisted Redux participant only invests $10,500, the maximum amount allowable in a TSP account,[12] he will still achieve greater value from his Redux retirement. This is true regardless of when he withdraws the money and regardless of tax implications.[13] Suppose the member does not wish to restrict the use of his funds by investing in a TSP account, but instead invests the entire $30,000 bonus, after taxes, in a taxable investment account.[14] The Redux retirement plan is still the best choice for the member, who will realize an additional $125,224 if he withdraws the invested money at age sixty-two.[15]

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8. The author made various assumptions based upon average military career patterns. Presumably, members will retire after twenty-two years of service. For fiscal year 1998, the average length of service for non-disability retirements for enlisted and officers was 21.7 and 24.2 years respectively. E-mail from Mike A. Dove, Defense Management Data Center (West), to author (Mar. 27, 2000) (on file with author).

Enlisted members were assumed to be forty-two years old and have achieved the rank of E-7 upon retirement. Officers would be age forty-four and have achieved the rank of O-5. Mr. Max Beilke, stated that the average ages of retirement for enlisted and officers were forty-two and forty-four years old respectively. Telephone Interview with Max Beilke, Department of Defense, Deputy Chief of Staff Personnel (Jan. 24, 2000). His statement however, does not agree with the average ages obtained by analyzing the data for fiscal year 1998. The average age for non-disability retirements for enlisted and officers was 41.1 and 46.4 years respectively. The average ranks upon retirement for enlisted and officers were E6.9 and O4.9 respectively. E-mail from Mike A. Dove, Defense Management Data Center (West), to author (Mar. 27, 2000) (on file with author). The author based calculations on Mr. Beilke's statement, and this difference affects portions of Table 1. *See* ARMY LAW., Sept. 2000, at tbl. 1 (Redux Data), *at* http://www.jagcnet.army.mil/TJAGSA (Publications, 2000, September, Miscellaneous Administrative Information). The effect on the values for enlisted members is minimal. The difference does not affect the basic conclusions for officers, although the statements regarding specific ages are less valid. Regarding rank, therefore, the author "rounded up" the ranks to E7 and O5 for calculations regarding pay.

The author combined the data regarding years of service, age and rank with assumptions regarding economic factors. Those assumptions were an inflation rate of 3.5%, an annual active duty pay raise of 3.5%, a tax rate of 16%, and a rate of return on investments of 10%. Mr. Saul Pleeter, an economist, indicated that he used a tax rate of 16% in his calculations regarding the military and the TSP. He based the 16% on a study done on marginal tax rates in the military. Researchers completed the study as part of the Seventh Quadrennial Review of Military Compensation. Telephone Interview with Saul Pleeter, Assistant Director of Compensation, Office of the Assistant Secretary of Defense Force Management Policy (Jan. 24, 2000). The 16% figure is in keeping with a report done by the Congressional Research Service. Authors of that report reviewed data on individual federal income tax returns for 1995, 1996, and 1997. The average tax rate expressed as a percentage of adjusted gross income was 14.7%, 15.2%, and 15.4% for the three years respectively. Tax Notes Today, *#22 2000 TNT 18-22 CRS Report on Individual Tax Returns for 1995-1997,* TAX ANALYSTS, Jan. 27, 2000, LEXIS, All Sources Library, Tax Analysts Tax Notes Today File.

Finally, the author made two significant assumptions regarding service members' financial situations. First, Redux retirees can afford to have lower levels of retirement pay, i.e., these members will not need the difference in income between the High-Three and the Redux retirement programs to meet their basic needs. Second, High-Three retirees cannot afford to invest any of their retirement pay.

9. The enlisted member would allocate his bonus as follows: $3120 for federal income tax, $10,500 in a TSP account, and $16,380 in a taxable investment account. The author assumed a 16% tax liability. By investing the maximum amount possible in a TSP account, the service member would enjoy the benefits of tax deferment.

10. The taxes due upon withdrawal or distribution would be the taxes on any income earned from the investment. The income taxes due on the receipt of the bonus would be due before April 15 of the year after the bonus is received.

11. If the Redux participant withdrew his savings at age sixty-two and paid taxes from his accumulated investment, he would have $119,807 more than a comparable High-Three participant. *See* ARMY LAW., Sept. 2000, at tbl. 1 (Redux Data), *at* http://www.jagcnet.army.mil/TJAGSA (Publications, 2000, September, Miscellaneous Administrative Information).

12. *See supra* note 7.

13. *See* ARMY LAW., Sept. 2000, at tbl. 1 (Redux Data), *at* http://www.jagcnet.army.mil/TJAGSA (Publications, 2000, September, Miscellaneous Administrative Information).

14. The enlisted member would allocate his bonus as follows: $4800 for federal income tax and $25,200 in a taxable investment account. Presumably, the member has a federal tax liability of 16%.

The Redux retirement plan begins to yield lower future values than the High-Three plan when the enlisted member invests $8000 or less in a TSP account. With an $8000 investment, the Redux member would have greater value for the first ten years of retirement. In the eleventh year, the value of his retirement program would be very similar to the accumulated pay difference between High-Three and Redux. From the twelfth year on, however, the High-Three plan has a greater future economic value.[16] The High-Three plan may be advantageous to enlisted members that would not invest significant portions of their career status bonus.

Commissioned Service Members

For officers, the choice between retirement programs is more complex. The member will obtain greater values with Redux, but higher investment amounts and greater time-periods are required. At the extreme, if a Redux participant invests his entire bonus after taxes,[17] he will achieve greater value from his Redux retirement regardless of when he withdraws the money and regardless of his tax liability.[18] Suppose he does not wish to restrict the use of any of his funds by investing in a TSP account and invests the entire bonus, after taxes, in a taxable investment account.[19] He will still achieve greater value in a Redux program, except for the fifteenth to nineteenth years of military retirement (ages fifty-eight to sixty-two). This is the period immediately before the adjustment in pay for Redux members.[20]

If the officer only invests $10,500 in a TSP account,[21] the Redux retirement will not yield greater value until the twenty-fifth year of retirement. At that point, the officer will be about sixty-eight years old. The pivotal point between the retirement programs occurs when an officer invests about $19,000.[22] With a $19,000 investment, the Redux program will produce greater economic values for all years of retirement except for the years preceding the Redux pay adjustment at age sixty-two.[23] Therefore, an officer planning for retirement must consider carefully when he will withdraw any funds invested for the future.

Department of Defense Retirement Calculator[24]

Enlisted members and officers can compare the differences between the High-Three and Redux retirement programs online. Personnel at the DOD developed software to assist service members in comparing the two programs. Programmers designed an online calculator to allow members to make assumptions regarding their particular retirement circumstances. Members can project their ages, years of service, and probable grades at retirement. Members can also plan on how they will invest or use their bonuses. Finally, members can project economic variables such as pay raises, inflation rates, tax rates, and investment return rates. The DOD calculator is simple to use and provides clear explanations. The accompanying text is helpful, and the program provides charts, tables, and examples. Service members should definitely avail themselves of this tool when comparing retirement plans.

Service members should be aware of one assumption built into the software that may not be valid for their circumstances. Programmers based their calculations for the High-Three option on continuous investment of ten percent of the members' basic pay. The designers of the program assumed High-Three retirees would invest the difference between their pay and that of Redux retirees' pay. High-three retirees receive at least fifty percent of their base pay, while Redux retirees receive at least forty percent. In making this assumption, the designers tried to provide similar conditions for

15. If the Redux participant withdrew his savings at age sixty-two and paid taxes from his accumulated investment, he would have $105,188 more than a comparable High-Three participant. *See supra* note 13.

16. *Id.*

17. The officer would allocate his bonus as follows: $3120 for federal income tax, $10,500 in a TSP account, and $16,380 in a taxable investment account. Presumably, the member has a federal tax liability of 16%. By investing the maximum amount possible in a TSP account, the service member would enjoy various tax benefits.

18. *See supra* note 13.

19. The officer would allocate his bonus as follows: $4800 for federal income tax and $25,200 in a taxable investment account. Presumably, the member has a federal tax liability of 16%.

20. At age sixty-two, Redux members' pay increases due to a one-time adjustment. *See infra* appendix entitled *Retirement Programs Available to Active Duty Service Members*.

21. *See supra* note 7.

22. The officer would allocate his bonus as follows: $3120 for federal income tax, $10,500 in a TSP account, and $8500 in a taxable investment account. Presumably, the member has a federal tax liability of 16%. By investing the maximum amount possible in a TSP account, the service member would enjoy various tax benefits.

23. *See supra* note 13.

24. Department of Defense, *Retirement Calculator, at* http://pay2000.dtic.mil (last visited Aug. 30, 2000) (Retirement Choice, Personalized Calculator).

both retirement options. The provided both groups of retirees with an investment portion and both groups with forty percent of their base pay for expenses.[25]

Unfortunately, the programmers did not provide an investment choice for the High-Three option. Users cannot remove the investment portion of the High-Three program as they can with the Redux option. They must accept that they will invest ten percent of their base pay under the High-Three plan. As a result, the software usually calculates greater future economic values for the High-Three retirement plan.

Members using the DOD retirement calculator must be realistic about their savings plans. Upon retirement, many members will not be in financial positions to invest money in a continuous manner. They may be starting new careers, and may have children entering college. In addition, members should continue to fund their Roth IRA accounts. Realisticially, members may not be able to afford to invest significant portions of their Redux bonuses or their retirement pay.

Conclusion

The Redux retirement plan should produce higher future economic values for all retirees, provided service members invest significant portions of their career status bonuses.[26] Despite that basic truism, the values of service members' retirement plans are very dependent upon individual circumstances. This article relies on a set of assumptions that may not hold true in all cases. Rates of return on investments may be lower for service members unwilling to assume the risks generally accompanying higher rates of return. Officers using Redux must time withdrawals from their investment funds very judiciously to ensure high future economic values. The DOD online calculator is a helpful tool to compare the Redux and High-Three retirement plans. Before choosing a retirement plan, a service member must consider carefully their circumstances, and develop individual assumptions that will enable the member to select the plan that best fits his needs.

25. Telephone Interview with Tom Tower, Assistant Director for Compensation, Undersecretary of Defense for Personnel and Readiness (Jan. 27, 2000).

26. Other authors agree that the Redux retirement program will yield higher future values than the High-Three program provided members invest significant portions of their bonuses. Tom Philpott, *The New World of Retirement Options*, A.F. MAG., Feb. 2000, at 58.

APPENDIX

Retirement Programs Available to Active Duty Service Members

The basic structure of the present retirement system for the military has remained unchanged since the end of World War II.[1] In 1947, Congress authorized a common system for all of the services and for both officers and enlisted members.[2] The system provides an annuity for members who serve for at least twenty years.[3] Members serving less than twenty years do not receive any retirement benefits.[4] For retirees, the lifetime annuity begins upon discharge from the service and ranges from forty to seventy-five percent of basic pay. Congress provided yearly cost-of-living adjustments (COLAs) for the annuity. Subsequent legislation by Congress created three separate retirement programs within the basic system. The DOD refers to the original program as "Final Pay." The other two programs are commonly called High-Three and Redux.[5]

Date of Entry Determines Applicable Retirement Program

The date of entry into service determines which retirement program is available to the service member. Members who entered service before 8 September 1980 will use the Final Pay program. Members entering after 8 September 1980, but before 1 August 1986 are under the High-Three program. The newest service members are under the Redux program. Each succeeding program provides lesser economic value for members. The High-Three program provides five to seven percent less value than the Final Pay program.[6] The Redux program represents roughly a seventeen- percent loss compared to the average High-Three retiree and a twenty-five percent loss compared to the average Final Pay retiree.[7]

Pay Calculations: Multipliers and COLAs

The programs differ in the way the annuities and COLAs are determined. The Final Pay program annuity is determined by taking the multiplier of 2.5% times the years of service,[8] times the base pay for the member's rank upon retirement. The High-Three program uses the same formula, but the base pay is the average of the member's highest three years of base pay. The Redux formula differs from the High-Three formula by using a multiplier of 2% for the first twenty years of service and 3.5% for years twenty-one to thirty.[9] At age 62, Redux retirees begin to use the same multipliers used by High-Three retirees.

The COLAs overlay the three formulas. The Final Pay and High-Three programs provide yearly COLAs sufficient to offset the prior year's inflation rate as measured by the government's Consumer Price Index. The Redux program caps each COLA at one per-

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1. While the basic structure of the program has remained unchanged, numerous legislative changes to the program have occurred. Critics of the program maintain that change is still necessary. Critics argue it is unfair for members to leave (versus retire) service without some retirement benefits. Only about 35% of officers and 12.5% of enlisted members will retire from the military. The majority of service members leave with no retirement benefits. Critics maintain that the military should not be exempt from the Employee Retirement Income Security Act which requires private sector employers to vest their employees in a retirement system after about five years of service. Further, critics claim that the system is inefficient, too costly, and too inflexible for the military. BETH J. ASCH, RICHARD JOHNSON & JOHN T. WARNER, REFORMING THE MILITARY RETIREMENT SYSTEM 2 (1998).

2. *Id.*

3. The annuity program is noncontributory—members do not contribute funds for their retirement program.

4. Critics maintain that the lack of retirement benefits for members leaving service without retiring is a weakness in the military retirement system. *See supra* note 28. Members can "carry forward" a retirement benefit if they become reservists. If members enter the Ready Reserve, they can apply their active military service towards a retirement pension from the reserve programs. A discussion of the retirement program available to reservists is beyond the scope of this appendix. For information on the retirement program for reservists see RESERVE FORCES POLICY BOARD, RESERVE COMPONENT PROGRAMS: THE ANNUAL REPORT OF THE RESERVE FORCES POLICY BOARD (1999).

5. Congress made major changes to the military retirement program in the MRRA of 1986, commonly called Redux.. *See* Sydney J. Freedberge Jr., *Smart Salute*, NAT'L L.J., Jan. 30, 1999, at 265.

6. Tom Philpott, *The New World of Retirement Options*, A.F. MAG., Feb. 2000, at 58.

7. *Department of Defense Authorization for Appropriations for Fiscal Year 2000 and the Future Years Defense Program: Hearings on S. 1059 Before the Committee on Armed Services*, 106th Cong. pt. 5, 189 (1999) (statement of the Military Coalition).

8. The annuity is capped at thirty years of service. Thus, 75% of base pay is the maximum amount that members can receive as an annuity payment.

9. Given the higher multiplier for latter years, members who serve thirty years under the Redux program can receive 75% of their base pay as annuity payments.

centage point below inflation with a one-time adjustment at age sixty-two. At age sixty-two, the member's annuity is adjusted to reflect COLAs received under the other programs. After the adjustment however, the member returns to COLAs at one percentage point below inflation.

Choice Between High-Three and Redux

In response to concerns about recruiting and retention, Congress modified the military retirement system in 1999. The Defense Authorization Act for fiscal year 2000 provided a choice for members eligible for the Redux program.[10] After fifteen years of military service, members can agree to serve an additional five-years, receive a $30,000 career-status bonus, and retire under Redux. Alternatively, members can continue to serve and retire under High-Three. Members should consider many variables when choosing between High-Three and Redux. In general, members who invest significant portions of their career-status bonuses will achieve greater future values from the Redux retirement program.[11]

10. National Defense Authorization Act of 2000, Pub. L. No. 106-65, § 641, 113 Stat. 512 (1999).

11. For further information regarding the choice between programs, see Philpott, *supra* note 7, at 58.