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Federal Employees Need to Rethink How Much Income They Will Need in Retirement
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Many financial planners advise clients who are close to retirement to replace at least 70 to 80 percent of their pre-retirement gross salary with pension-type income in order for them to survive financially throughout their retirement years. But new research indicates that the "70 to 80 percent" replacement rule is not applicable for many soon-to-be retirees. This column discusses what this new research means for federal employees, especially those who are within 10 years of their retirement date.

It is especially important for employees who are within five years of their anticipated retirement date to determine their "replacement income" percentage, defined as the percentage of their pre-retirement gross salary income that they will need in retirement. For federal employees, "replacement income" comes from pension-type income in the form of CSRS and FERS annuities, military pensions, Social Security retirement benefits, IRA's, perhaps private pensions, and Thrift Savings Plan (TSP).

A suggested way for retiring employees to come up with a "replacement income" percentage is for them to total up all of their "expected" expenses in retirement. Examples of "expected" expenses in retirement include health and long-term care insurance premiums and out-of-pocket health care bills, Medicare Part B premiums, travel, gifts to children and grandchildren, food, entertainment, housing and maintenance expenses, and charitable contributions. Employees should compare the expected amount of these expenses with anticipated CSRS and FERS annuity income, Social Security retirements benefits IRA withdrawals, military pensions, and TSP income. This should give retiring employees a better idea of what percentage of their pre-retirement salary income they will need to replace with pension-type income.

Here are some additional guidelines for employees in determining their "replacement income" percentage:

Certain employee expenses will be lower or disappear in retirement.

One the largest employee expenses that federal employees have is their bi-weekly contributions to their retirement plans (CSRS or FERS), Social Security (FICA tax) and to the TSP. A CSRS employee contributes 7 percent of their after-taxed wages to the CSRS Retirement and Disability Fund. A FERS employee contributes 0.8 percent of their after-taxed wages to the FERS Retirement and Disability Fund, plus 6.2 percent of their gross wages is contributed to Social Security via the FICA tax. Employees close to retirement are contributing on average 10 to 20 percent of their paychecks to the TSP. Some employees contribute regularly to IRAs. In total, most federal employees approaching retirement save on average about 15 to 25 percent of their salaries for retirement. Once an employee fully retires, their retirement plan contributions cease. In short, whatever the amount an employee saves for retirement effectively lowers their preretirement take-home income.

Other employee-related expenses can also be lower or be eliminated in retirement. These expenses include train tickets and other commuting expenses such as parking, gas, car "wear and tear", dry cleaning bills, lunches out and college savings and expenses.

"True" inflation and life expectancy.

For 2013 and 2014, CSRS and FERS annuitants and Social Security recipients received cost-of-living adjustments (COLAs) of less than two percent; namely, 1.7 percent COLA in 2013 and 1.5 COLA percent in 2014. These COLAs, however, mask the increase of living costs for particular items for which retirees typically have more of. For example, medical costs are increasing annually at a greater rate compared to the consumer price index (CPI). The CPI is the gauge that is used to determine COLAs for urban workers. There has also been discussion in Washington of using a "chained" COLA to determine the annual COLA for annuitants and Social Security recipients, resulting in even smaller COLAs for federal annuitants. Retiring employees therefore have to consider that some of their expenses may be increasing annually in cost at a greater percentage compared to how their annuities are increased by COLAs.

Life expectancy is another important consideration. The question of life expectancy is particularly important in determining how much a TSP account owner can safely withdraw from their TSP account each year without running the risk of depleting one's TSP account during their retirement. If longevity is common in a TSP account owner's family, then the account owner should take that into consideration when determining how much can be safely withdrawn annually from the TSP.

The real challenging question: Will there be changes in lifestyle during retirement?

Some of the questions that soon-to-be retirees should ask themselves are: (1) Do they plan to have a vacation house?; (2) Do they plan to engage in expensive hobbies once they retire?; (3) Will they travel quite frequently, especially to expensive parts of the world, such as Europe?; and (4) Will they be giving lots of gifts to their children or to charitable institution? The answers to these questions will give soon-to-be retirees a better idea of how much additional income they may need throughout their retirement.

Planning for the unexpected and "shocks".

Costly illnesses, long-term care and unexpected life style changes can suddenly undo a retiree's estimated income needs calculation. Having to suddenly take care of a relative -- for example, raising a grandchild - can substantially increase a retiree's living costs, particularly for food, support and education.

A "wild card" is where a retiree plans to live.

Property taxes, state and local income taxes, state and local sales taxes and personal property taxes can play a big part of how much income a retiree needs in retirement. Each of these taxes varies geographically, by state and by country. Many retirees are now moving to other countries that are considered to be "retiree friendly". States that retirees are moving to include Florida, Tennessee, Texas, and Wyoming that have no state and local income taxes. Delaware, Montana, New Hampshire, Oregon and Alaska have no state and local sales taxes. New York, Pennsylvania, Massachusetts, Alabama and Mississippi do not tax federal, state and local pensions (government sponsored defined benefit plans). New York State does not tax the first $20,000 per year of defined contribution plan withdrawals, such has 401(k) plans and TSP withdrawals.

Another major consideration is housing costs. Paying off a mortgage prior to retirement or selling a house, paying off the existing mortgage and buying a less expensive primary residence with cash means less income is needed to pay for monthly housing expenses. But employees who plan to retire to more expensive regions of the country where housing maintenance costs, property taxes and homeowner's insurance are higher in cost should be aware that their monthly housing expenses may be higher compared to their monthly housing expenses they had when they lived in other parts of the country.

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