Information for Eligible Career Status Bonus (CSB) Members

Introduction -

You have been identified as potentially eligible for a career status bonus (CSB) of $30,000. If eligible, you will have the choice of remaining subject to the provisions of the High-3 Retirement System or electing a $30,000 CSB and being subject to retirement under REDUX (CSB/REDUX). The options are summarized in Table 1. To be an eligible member, you must:

1. Be on active duty
2. Complete 15 years of active duty service
3. Have a DIEMS / DIEUS (Date of Initial Entry to Military / Uniformed Service) that is August 1, 1986 or later, and
4. Qualify under Service regulations for retention to 20 years of active duty service.

TABLE 1

Bonus Option Comparisons		
OPTION	**High-3 Retirement**	**CSB / REDUX**
Bonus	**None**	**$30,000 at 15th Year of Service Paid either as 1 Lump Sum or in 2, 3,4, or 5 Equal Annual Installments**
Service Obligation	**None, but... Member Must Serve 20 Years to Qualify for Retirement**	**Member Must Agree to Remain on Continuous Active Duty to 20 Years of Service**
Retired Pay Computation		
System	**High-3**	**REDUX 1986 Military Retirement Reform Act**
Base	**Average Monthly Basic Pay over Highest 36 Months**	**Average Monthly Basic Pay over Highest 36 Months**
Multiplier	**2.5% per Year of Service**	**2.5% per Year of Service Less 1 Percentage Point for Each Year Less Than 30 Restored at age 62 to Same as High-3 System**
COLAs*	**Full Inflation Adjustment Equal to the Annual Increase in CPI-W****	**Reduced Inflation Adjustment Equal to Annual Increase in CPI-W minus 1 Percentage Point With A One-Time Readjustment at Age 62**

*** Cost-of-Living Adjustment**
**** Consumer Price Index for Urban Wage Earners and Clerical Workers**

It's Your Decision - The bonus election decision is yours to make. We recommend you make it on the basis of your personal perspective -- how you see things! Be certain you take a good look at the risks that may be involved. At the same time, we suggest you consult several sources to get a variety of viewpoints and preferences. It will make you better informed. You'll probably be happier if your decision is based on a well-balanced set of perspectives. Good luck!

OVERVIEW

If you're a member who is eligible for the Career Status Bonus (CSB), we suggest you:

(1) Read this paper to get started,
(2) Assess your personal career expectations,
(3) Determine your probable use of any bonus money,
(4) Decide what kind of risk you're willing to tolerate,
(5) Work through at least a basic analysis of the options, and
(6) Discuss the decision with two or more advisors whom you trust.

As stated above, this paper can help you get started. It explains the options, looks at some basic outcomes for specific assumptions, and highlights important considerations. Here's a brief outline:

1. **The $30,000 Career Status Bonus**
   The CSB and Taxes
   Options and Implications
      Tax-sheltered Investment in the Thrift Savings Plan (TSP)
      One Lump Sum or Multiple Annual Installments
      Other Investments of the After-Tax Balance
      Spend It Outright
   Basic Considerations

2. **REDUX Retired Pay versus High-3 Retired Pay**
   Differences in Retired Pay
      Reduced Multiplier
      Reduced Cost-of-Living Adjustments (COLAs)
   Projections and Comparisons Over Time
   Survivor Benefit Plan (SBP) Implications

3. **Consideration of the Risk and Other Factors**

In addition, we encourage you to use the CSB/REDUX decision analysis tool on line at http://militarypay.dtic.mil. The web site allows "what-ifs" so you can see some results based on your own circumstances and expectations. The site also has information on Basic Pay, Basic Allowance for Housing (BAH), Basic Allowance for Subsistence (BAS), and other aspects of military pay and benefits. It also has a link to the Thrift Savings Plan site where you can find information on how the TSP applies to members of the Uniformed Services. Your own Branch of Service may also have a web site with additional information and insight.

Section 1 - THE $30,000 CAREER STATUS BONUS (CSB)

The CSB and Taxes: If you elect the bonus, you will receive $30,000 in either one lump-sum payment or up to five equal annual installment payments, normally beginning about the 15th year of active duty service. Taxes on the bonus may vary significantly depending on your personal Federal tax bracket, applicable State taxes, and opportunities to avoid tax. This can have a big effect on the future value of the bonus money. One important tax possibility is that the entire bonus may be tax exempt for an enlisted member or warrant officer if the election is made effective while serving in a combat zone or Qualified Hazardous Duty Area (QHDA). This would be true if you qualify for the standard combat-zone (QHDA) tax-exemption on your basic pay for the month your election is effective. This is a one-time tax exclusion for the full bonus amount so it protects any future payments of the bonus if you take one of the multiple annual installment options, but it does not exempt from taxation any earnings derived from investment of the bonus money, even if you continue to serve in a combat zone or QHDA.

The CSB may qualify for deposit in the Thrift Savings Plan (TSP), a tax-deferred savings program for Federal employees, including members of the Uniformed Services. Further details are provided below.

Options and Implications: The greatest dilemma in choosing between the CSB/REDUX and the High-three retirement is deciding how to value the options over time and make comparisons. The bonus looks simple enough --- $30,000 whether taken in one lump sum or up to five annual installments. However, the true value of the bonus lies in its' potential, and that depends on what you do with it. Among the decisions to be made are:

(1) **How much, if any, to invest in the Thrift Savings Plan (TSP),**

(2) **Whether to take it in one lump sum or multiple annual installments,**

(3) **How to invest any remaining after-tax balance, and**

(4) **Whether to spend some of it outright.**

Making the choice of what to do with the bonus money is not easy. You can probably take our list of options and expand it into twenty actual ideas of what you might be interested in doing. Making choices can get complicated and confusing. Don't suffer the "paralysis of analysis" -- where you can't make a decision because you keep analyzing new options or using different assumptions. In the analysis below we try to avoid complexities but still cover the essentials. Now, let's look more closely at these four basic choices.

Choice #1. How much to invest in the TSP?

The TSP for military personnel began in early 2002. Participation limits are as follows:

Year	Percentage Limit	Annual Dollar Limit
2002	7%	$11,000
2003	8%	$12,000
2004	9%	$13,000
2005	10%	$14,000
2006	None	$15,000
After 2006	None	As increased by law

CSB funds deposited into the TSP and subsequent earnings on those deposits are not taxed during the year they are received, but in the year they are withdrawn. This lets you invest more dollars more quickly and reap greater investment growth each year compared to investing after taxes and paying tax on earnings realized each year. However, there are penalties for withdrawing funds early from a TSP account and a limited number of investment options.

To see the advantage of tax sheltering with TSP, consider $1,000 today and what would happen to it in a regular investment versus a tax-sheltered investment, both earning 6% per year.

		Tax-Deferred Investment		
Year	After-Tax Investment	Account Balance	=Tax Reserve	+ Net Assets
2002	$ 700	$1,000	$ 300	$ 700
2007	$ 860	$1,338	$ 401	$ 937
2012	$1,056	$1,791	$ 537	$1,254
2022	$1,594	$3,207	$ 962	$2,245
2032	$2,405	$5,744	$1,723	$4,021

In the after-tax column, although we began with $1,000 of income, $300 in tax must be paid, leaving only $700 to be invested. Each year taxes must be paid on any earnings. Thus, in this column, the amounts shown are your assets free and clear.

In the tax-deferred investment the whole $1,000 is deposited to the account. The full account balance is shown in the first column. As a precaution, because taxes must still be paid upon withdrawal, we divide this account balance into a tax reserve plus the true net assets. The advantage of the tax-deferred investment is that you keep earning returns on the full account balance, including the tax reserve. Thus, in year 2032, the tax-deferred account has a total balance of $5,744, of which $1,723 is marked to pay taxes upon withdrawal, leaving $4,021 in true net assets if your tax rate is still 30%. Probably your tax rate will be somewhat less in retirement so the net after-tax amount would be even greater. In the above example, after 30 years, the net assets of a tax-deferred investment is two-thirds more than an after-tax investment when the annual rate of return is 6% -- $4,021 compared to $2,405.

You must be a TSP participant, already depositing a portion of your basic pay each month, in order to deposit any portion of the CSB in the TSP. This affects the amount you can deposit each year. For example, if you are participating in the TSP and contributing $2,000 from your basic pay in 2002, the maximum you could deposit from the CSB would be $9,000.

You will be able to put more of the CSB into the TSP if you qualify for a QHDA or combat zone tax exclusion when you make your election. In this case, any portion of the CSB not counted as taxable income can be deposited in the TSP up to $30,000 or 25 percent of your annual compensation, whichever is less. For example, if you qualified for this option and had total annual compensation of $75,000, your contributions for that year would be limited to no more than 25 percent of $75,000 -- or $18,750. Subtracting your $2,000 basic pay contributions leaves $16,750 you could contribute from the CSB. Rules for computing total compensation and other regulations on TSP deposits are published separately. Some of the primary information is available on line at www.tsp.gov -- select the information for the Uniformed Services.

There are other investments with tax advantages that may be equal to those of the TSP, such as a Roth or traditional Individual Retirement Account (IRA). The advantages and restrictions vary with your personal situation, so you should see a trained advisor for details.

Choice #2. Take the bonus in one lump sum or in multiple annual installments?

This decision is closely related to your decision on how much to put in the TSP. If you take the bonus and have decided how much to put in the TSP, then you need only elect to receive the bonus in the minimum number of annual installments that will allow you to make your desired TSP deposits. We take the same $1,000 investment we looked at above, but now look at three options on the tax-deferred investment -- the lump sum deposit of the full $1,000, plus an option with two deposits of $500 and another option with five deposits of $200. The following results show only the net assets of the tax-deferred investment options.

		Tax-Deferred Investment - Net Assets		
		Payment Option		
Year	After-Tax Investment	Lump Sum	Two Installments	Five Installments
2002	$ 700	$ 700	$ 350	$ 140
2003	$ 729	$ 742	$ 721	$ 288
2004	$ 760	$ 787	$ 764	$ 446
2005	$ 792	$ 834	$ 810	$ 612
2006	$ 825	$ 884	$ 859	$ 789
2007	$ 860	$ 937	$ 910	$ 837
2012	$1,056	$1,254	$1,218	$1,119
2022	$1,594	$2,245	$2,181	$2,005
2032	$2,405	$4,021	$3,907	$3,590

This simple analysis tells us that, given an equal rate of return on invested funds: (1) A tax-sheltered fund is advantageous, and (2) It is better to spread out the payments if necessary to make a tax-deferred investment like the TSP, but (3) It is best to do it as quickly as possible. For the CSB, if you want to put it in the TSP, take it in four installments of $7,500 if that will let you put it all in the TSP. If three installments of $10,000 will work, that is even better, and so on.

Choice #3. How to invest any remaining after-tax CSB balance?

Other choices for investing abound! You may want to put a down payment on a home, pay off some debt, improve your education, or invest in a business of your own. The risk associated with some of these investments may be considerable, but the potential return could also be substantial. Some, or all, of your investment earnings may be subject to income tax each year, which will tend to reduce your accumulated investment and rate of growth. Tax treatment of investment earnings may vary widely but must be considered to accurately assess their value. **All the more reason to seek advice from a capable and trusted source.**

(1) We want to emphasize that we can't show you the risk for any given investment option. You must decide the risk potential and how you will let that risk influence your decision. Generally, higher potential returns carry a higher risk. The rate of return on any investment is crucial to the future value of that investment. Even a relatively small difference, such as 6% versus 8%, can have a substantial impact. Let's compare three investments of $1,000 over 30 years, ignoring tax considerations. These dramatic differences show how the assumed rate-of-return is crucial to the outcome of any comparison. It's even risky to make assumptions about the rate of return on investment!

Year	4%	6%	8%	10%
2002	$1,000	$1,000	$ 1,000	$ 1,000
2012	$1,480	$1,791	$ 2,159	$ 2,594
2022	$2,191	$3,207	$ 4,661	$ 6,727
2032	$3,243	$5,744	$10,063	$17,450

Rates of return less than 5% are generally thought to be achievable with fairly low risk. Some low return investments can carry significant risk; so don't assume a low return projection means your investment is a sure thing! Rates around 8% are common, but usually carry greater risk. Rates over 8% have an increasingly significant risk of earning less than expected, as well as the potential to lose a portion of the original investment (or even all of it in some cases). Base your decisions on what you feel is reasonable, recognize the risk, and be certain you can live with that risk over the long haul.

Choice # 4. How much, if any, of the bonus to spend outright?

You might want to spend some of the bonus on a car, vacation, or similar consumable or depreciable item. Such spending may give you a great vacation or a really nice car, but the money will be gone and the value of what you bought will either be gone immediately, or at best will depreciate quickly. **You'll give up the potential for investment earnings and may have nothing available to meet future needs. Think carefully about how much you really want something now versus what you're giving up later!** On the other hand, spending the money outright may allow you to avoid further debt or eliminate a significant amount of current debt. In this case, you could analyze such spending more as an investment than as an outright expense that has no future value. Be careful of your

assumptions and projections in this kind of comparison. It might be well to discuss such an approach with a financial advisor.
Spending today impacts the future! Suppose you want to take a really great vacation using $4,000 of the CSB. First, you'd have to pay taxes on the $4,000. A 30% tax rate would leave you only $2,800 for your vacation and when the vacation is over, the entire $4,000 will be just a few great memories. While there's a lot to be said for great memories, you also need to think about the future! Since taking the bonus results in reduced retired pay, the potential future value of the money is a valid perspective. Therefore, we consider the potential of adding the full $4,000 to your TSP account and earning a 6% annual rate of return. At age 65 you'd have $22,974 more in your account. You could then withdraw it, pay 30% in tax, and have $16,082 to spend on a great retirement vacation. Meanwhile, 3% annual inflation would have pushed up prices so the original $2,800 vacation would now cost $6,796. In this example, your after-tax funds would equal 240% of that so investing the money today would earn you a vacation that's more than twice as nice when you retire at age 65. Of course, if you use this approach for every decision, you would deny yourself everything forever. But, as stated above, since the bonus reduces your retired pay, looking at the potential value is a valid perspective for this decision.

Basic Considerations: To briefly review what we've seen with respect to our four basic choices if you take the bonus, we suggest you:

1. Carefully consider taking full advantage of tax-free investments like the TSP,

2. Receive the bonus in the minimum number of annual installments to put what you want in the TSP,

3. Invest cautiously and avoid speculative high-risk investments unless you are comfortable with the risk, and

4. Avoid spending bonus payments outright on consumables and items that depreciate quickly.

Section 2 - REDUX RETIRED PAY VS HIGH-3 RETIRED PAY

Differences in Retired Pay: If you elect the CSB, you must:

(1) Agree to remain on active duty until you have 20 years of active duty service, and

(2) Have your future retired pay computed under the provisions of the 1986 Military Retirement Reform Act (1986 MRRA, also called **REDUX**). REDUX retired pay will be less than retired pay under the High-3 system due to:

A reduced multiplier until age 62: For each year short of 30, the retired pay multiplier under REDUX is 1 percentage point less than the High-3 multiplier. The REDUX multiplier is restored at age 62 to be exactly the same multiplier as under the High-3 system.

Retired Pay Multiplier for 20 to 30 Years of Service											
System	Years of Service										
	20	21	22	23	24	25	26	27	28	29	30
High-3	50.0%	52.5%	55.0%	57.5%	60.0%	62.5%	65.0%	67.5%	70.0%	72.5%	75.0%
REDUX	40.0%	43.5%	47.0%	50.5%	54.0%	57.5%	61.0%	64.5%	68.0%	71.5%	75.0%

Reduced annual Cost-of-Living Adjustments (COLAs): Your COLAs under REDUX are 1 percentage point less than inflation as measured by the Consumer Price Index for Urban wage Earners and Clerical Workers (CPI-W). The following chart compares the High-3 and REDUX COLAs for selected rates of inflation. COLAs are set to the nearest 1/10th of 1 percent. At age 62, a COLA readjustment is made under REDUX to increase retired pay to equal the same retired pay amount as the High-3 retired pay when taken in conjunction with the multiplier readjustment. After age 62, reduced COLAs will again apply.

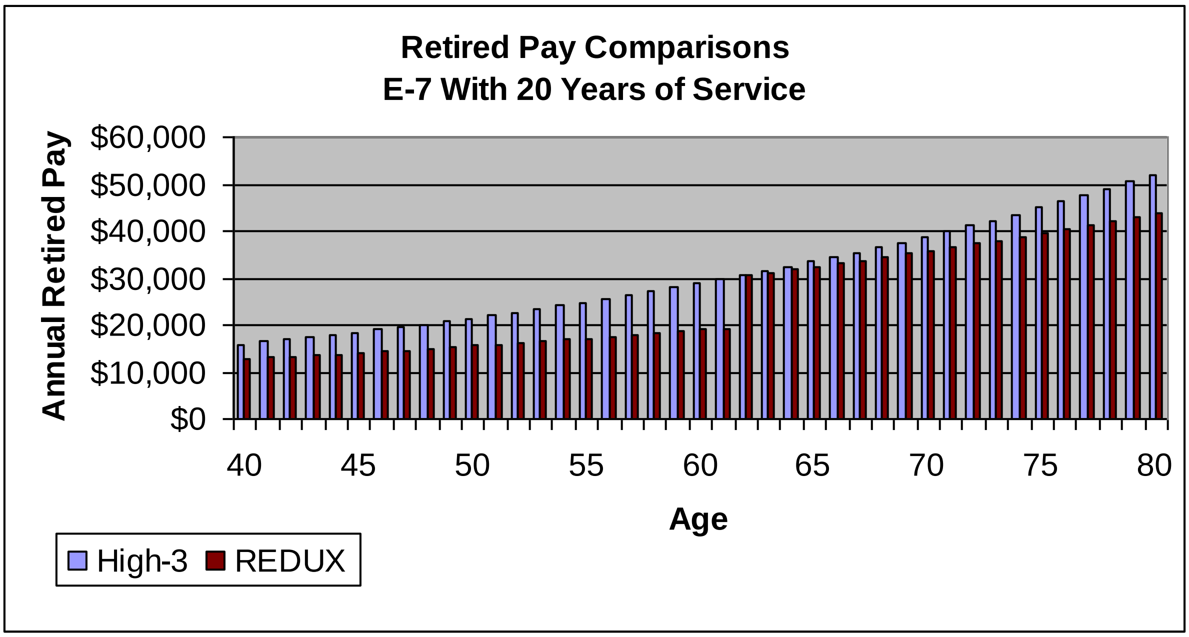
Annual Retired Pay Cost-of-Living Adjustment										
System	Observed Increase in Consumer Price Index (CPI-W)									
	0.5%	1.0%	1.5%	2.0%	2.5%	3.0%	3.5%	4.0%	4.5%	5.0%
High-3	0.5%	1.0%	1.5%	2.0%	2.5%	3.0%	3.5%	4.0%	4.5%	5.0%
REDUX	0.0%	0.0%	0.5%	1.0%	1.5%	2.0%	2.5%	3.0%	3.5%	4.0%

Projections and Comparisons Over Time:

We now want to compare REDUX to the High-3 retirement by looking at an E-7 who retired at age 40 with 20 years of service. We assume inflation is 3% each year and the retiree lives to be 80 years old. Chart 1 shows the actual gross retired pay each year. The pattern of retired pay is informative! First, there is the initial difference due to the reduced multiplier. This is greatest if you retire with just 20 years of service. The gap then increases each passing year due to the reduced REDUX COLAs before age 62. At age 62, REDUX retired pay is increased to exactly equal the High-3 retired pay. After that, a gap again develops as a result of the reduced REDUX COLAs.

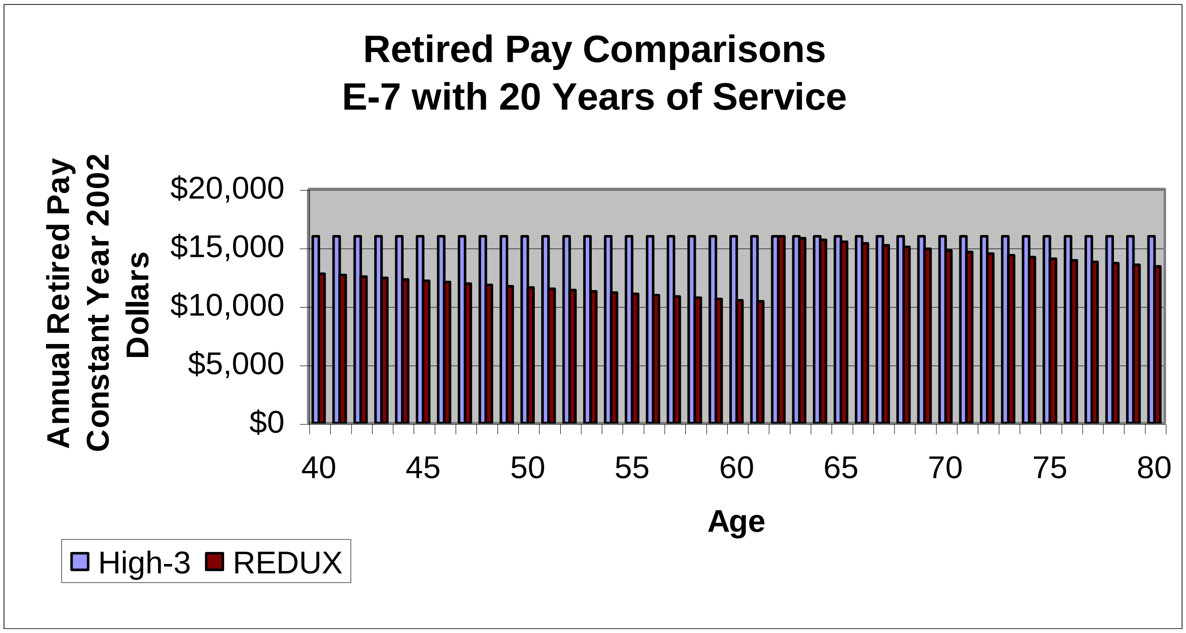
With 30 years of service, the patterns would be similar with two main differences: First, the levels of both REDUX and High-3 retired pay start out equal to 75% of High-3 average basic pay -- there is no multiplier reduction with 30 years of service. Second, the gap won't grow as much before age 62 because you would be 10 years older (closer to age 62) at the time of retirement. **This is an important consideration -- the longer you serve and the older you are at retirement, the less retired pay you lose under REDUX retirement.**

CHART 1



In this example, COLAs drive up the High-3 retired pay to be, at age 80, more than 3 times the initial value. Unfortunately, inflation does the same thing to the cost-of-living. While this member's retired paycheck at age 80 is 3 times what it was at age 40, it buys no more or less because of the cost-of-living has increased equally. Instead of looking at projected levels of retired pay in the future, we could look how much it would buy today (in the year 2002). We call this “Constant Year 2002” dollars. The results are shown in Chart 2. Note the same relative pattern of retired pay, but in this case, the High-3 retired pay is constant over the years, having the same purchasing power in every future year as it did upon retirement. The reduced COLAs under REDUX cause those payments to gradually decrease in terms of constant dollar value except for the age 62 readjustment.

CHART 2



An E-7 retired at age 40 with 20 years of service would receive High-3 retired pay through age 80 that totals over $654,000 constant Year 2002 dollars. REDUX retired pay would total only about $532,000, or $122,000 less (19%). But we must ask how this compares to the $30,000 bonus at the 15th year? Would anyone give up $122,000 from future retired pay in exchange for $30,000 today? It all depends on what you think you can do with the $30,000 versus the loss of retired pay under CSB/REDUX.

An analysis of the options requires that we make assumptions as to: (1) Grade at retirement, (2) Years of service at retirement, (3) Life expectancy (how long you'll live to collect retired pay), (4) Return on investments, (5) Tax rate, (6) Annual inflation (Consumer Price Index increase), and (7) Pay table increases before retirement.

Chart 3 shows the results for an E-7 who, at age 35, elects the CSB paid in five installments and deposits all funds into the TSP. He retires with 20 years of service and lives to 80 years, earning a 10% annual rate of return on all investments, with a 30% total tax rate, 3.0% annual inflation, and 3.5% annual pay increases. The amount shown is less than the amount on deposit in the TSP to account for the tax obligation that will be due when the funds are actually withdrawn. This investment is compared to the accumulating investment stream that would result from saving the added retired pay of the High-3 retirement versus REDUX retirement.

The bonus investment is initially greater simply because we have it in hand five years before retired pay even begins. However, as the High-3 versus REDUX pay gap widens approaching age 62, the High-3 investment takes over. After age 62, the CSB investment option again overtakes the High-3 investment due to the reduced difference in retired pay after age 62 and the advantage of greater growth of the tax-deferred TSP investment.

BUT, if we use an 8% rate of return on investment, the bonus option is much less attractive, as shown in Chart 4. In this case the High-3 investment option overtakes the bonus option at age 52 and stays ahead thereafter.

CHART 3

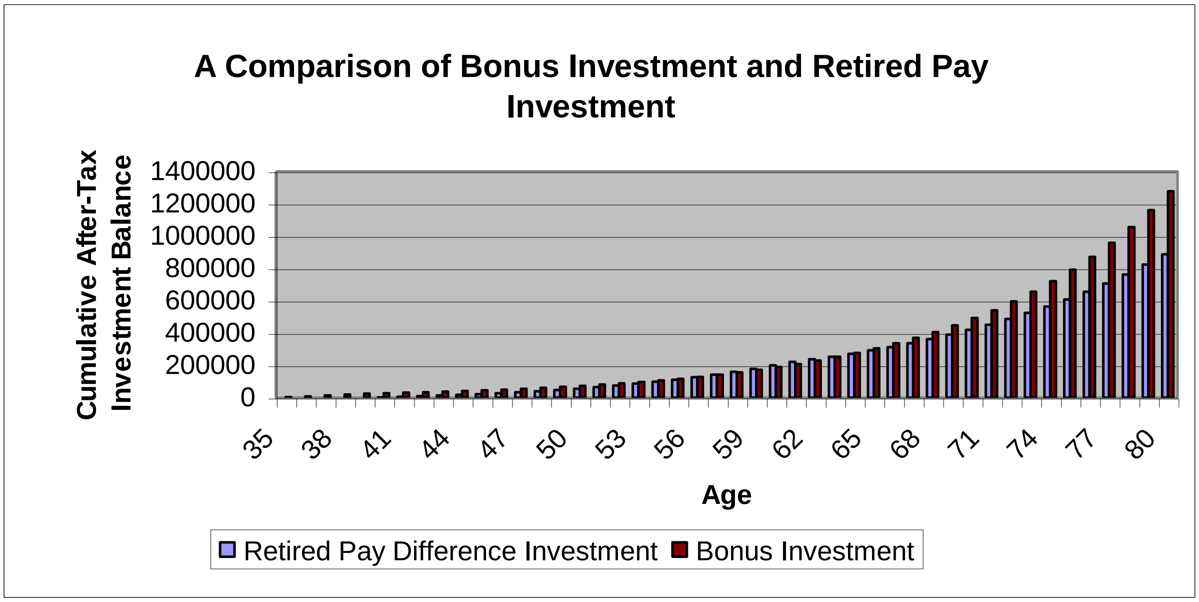
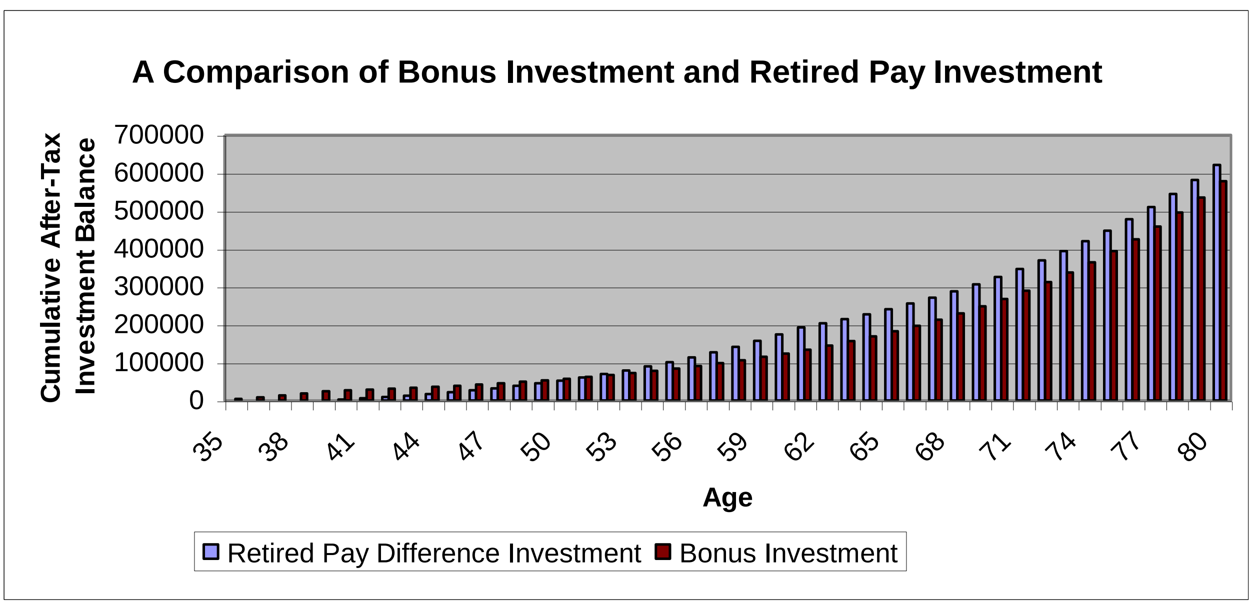
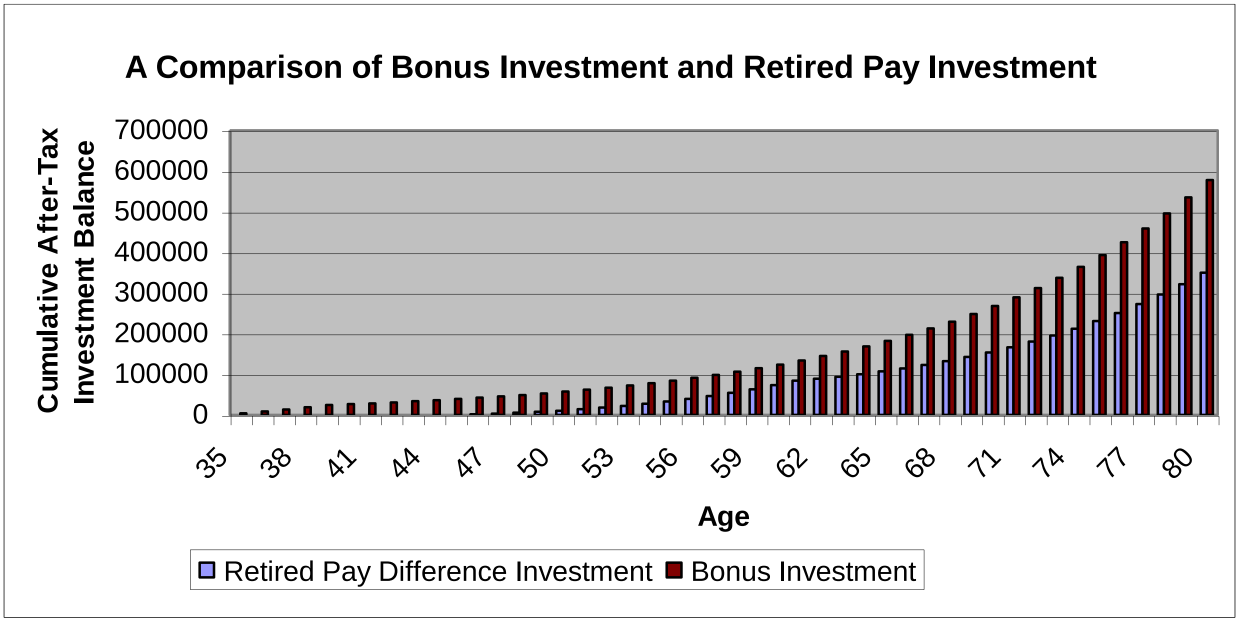


CHART 4



Caution! One set of numbers is not enough information to make this kind of decision. Also, you should consider the possibility that you might stay in service longer while your bonus investment grows and then retire with less reduction in retired pay. Charts 5 shows results for a case identical to chart 4, but for an E-8 retiring with 26 years of service.

CHART 5



In this case we see the CSB option would dominate in every year primarily because the investment grows for 11 years before retirement, and after that REDUX retired pay for 26 years of service is not that much less than the High-3 retired pay. The longer you plan to serve, the more attractive the bonus will be.

Survivor Benefit Plan (SBP) Implications

If you elect the CSB/REDUX option, you'll find that the SBP coverage available to you will work just a bit differently than it would under the High-3 retirement. The main difference is that under REDUX, the computation of premiums and the benefits payable is made without regard to the multiplier reduction for retirement with less than 30 years of service. As a result, premiums under REDUX while under age 62 will be a slightly higher percentage of retired pay than they will be under High-3 retirement. This causes SBP to be a bit less attractive under the REDUX system -- about 5-10% more expensive for lifetime cost versus benefits. The exact impact depends on when you retire and how you value money over time. We don't want to overly complicate your CSB/REDUX decision with an equally complex discussion of SBP, but it could make the CSB slightly less attractive.

SECTION 3- CONSIDERATION OF RISK AND OTHER FACTORS

The future never turns out exactly the same as that assumed for analysis. Think about the risk of things not turning out the way you expect! This will help you decide the amount and type of risk you're willing to tolerate. To do this, you need a feel for the way certain factors can affect results. Some of the effects are discussed below.

Inflation: Inflation determines the COLAs that increase your retired pay each year. However, the net difference between the High-3 retirement and REDUX isn't really very sensitive to the actual inflation because the difference is always 1 percentage point (less if inflation is less than 1%). REDUX retirement provides less retired pay in every case, but for a given career, the difference between actual inflation and your assumed rate of inflation should make little difference in comparisons of REDUX and High-3. The rate of inflation may affect the investment rate of return, but unless inflation is significantly higher than it has been any time recently, the bottom line is not likely to change due to a misestimate of inflation.

Age at Retirement and Length of Military Career: Generally, the longer you stay in service and the older you are at retirement, the more attractive you will find the CSB/REDUX option. This may have a big impact on your decision. Hopefully, you have a good feel for how long you want to stay in service and the probability that you will be allowed to stay that long. The percentage difference in High-3 versus REDUX retired pay gets smaller for each additional year of service. Not only is the multiplier reduction less, but there are fewer years until the reduction is removed at age 62. Invested wisely, the CSB grows with each passing year, and can be worth much more by the time you actually retire the longer you stay in service.

Increased Rates of Retired Pay Due to Pay Scale Increases and Higher Grade at Retirement: Working in the opposite direction of longer service are those factors that result in a higher initial level of retired pay for a given length of service. This would include the pay scale (basic pay table) growing faster than inflation as well as a promotion. The greater your initial retired pay for a given length of service, the more dollars you will lose with the CSB/REDUX. These factors work in the opposite direction of age and length of service, so you need to look carefully at your expectations and see how all of the factors play out together.

Return on Investment: We mentioned this before, but it bears repeating. If you take the CSB, your allocation of the money and the rate of return on any investment will drive the future value of the bonus option. If you can earn enough on your investments, the CSB/REDUX could be attractive, but the higher your assumed rate of return, the greater the risk that you won't actually earn that much. The assumed rate of return can significantly affect the desirability of the bonus option compared to the increased retired pay of the High-3 system. Also, remember that investing more in TSP by using the option for multiple annual installment payments can increase your total earnings when compared to similar investments (same rate of return) that are not tax-deferred.

Failure to complete 20 years of active service: If you elect the bonus and fail to reach 20 years of service as agreed, you will be required to repay the percentage of the CSB that is equal to the percentage of service you failed to complete compared to what you agreed to serve. In certain cases, repayment may be waived based on equity and good conscience. Repayment may be withheld from any money to which you are otherwise entitled.

Your Choice: All in all, the CSB/REDUX decision is not simple. We urge you to put at least enough effort into the decision to make yourself comfortable with your choice. Once you make that choice, you will want it to deliver as much for you as possible. Be forward looking and don't try to second-guess yourself after the fact.

One Last Thought: We urge you to spend time making your decision. There is a lot of complicated information to digest. Particularly, we urge you to visit our web site at http://militarypay.dtic.mil. If you go through at least a few “what-ifs” and study the results, you will get a feel for what factors might most affect your decision and how.

Best wishes and good luck!