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Equalizing Pre- and Post-Retirement Income: An After-Tax Approach

Richard B. Malamud[1]

Certified Financial Planners, CPAs, insurance agents, and other professionals often project the future financial needs of a client who is approaching retirement age. Their reports may say that in order to continue with their current lifestyle, a client will need to replace up to 100% of their current income. As one article points out:

> [W]orkers are underestimating the percent of pre-retirement income they might need in retirement. At present, many financial planners suggest replacing at least 75 percent of pre-retirement income in retirement, if not 100 percent ….[2]

Basic Assumptions: Net After-Tax Cash Flow on $90,000 Salary

The basic assumption for the following analysis is that the goal of a soon to be retired client is to retire with the same after-tax retirement income as the worker had before retiring. Thus, the retiree needs to be able to generate the same "income" from a combination of annual distributions from their pension, IRA, SIMPLE IRA, Keogh, SEP, 401(k), 403(b), 457, Social Security benefits, and other investments as was generated from their salary and pre-retirement investments.[3] This seems to imply that retirement income must

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[2] "Most underestimate amount of money needed for retirement," The Jackson Citizen Patriot, August 16, 2006, (www.mlive.com/business/jacitpat/index.ssf?/base/business-1/1155744345291290.xml&coll=3), (last visited 8/17/2006). For an interesting survey of retirement needs, see "The MetLife Retirement Income IQ Test, Findings from the 2003 National Survey of American Pre-Retirees" (www.metlife.com/WPSAssets/19819145661056390277V1FMetLife%20Retirement%20Income%20IQ.pdf#search=%22income%20needed%20for%20retirement%22) (last visited 8/17/2006).

[3] Income from investments, such as stocks and bonds is not illustrated because it does not apply to a large number of retirees. Also, if the pre-retirement investments generated $10,000 of income and all of it was spent on consumables, then in order to retain the same lifestyle, nothing will have changed. The retiree will continue to earn and pay tax on the $10,000 so it has only a very small effect on the calculations. As with all variables, and everyone's case is unique, the only way to determine the actual affect is to run the numbers through a tax or

equal 100% of the pre-retirement salary. This article will point out is that many retirees can continue to have the same income as they did when working even though their retirement gross income is 90% or less than their gross salary.[4]

Suppose a married couple wants to replace a salary of $90,000 per year with pension and IRA distributions and obtain the same after-tax cash flow. If you asked the above couple what their current after-tax cash flow is, they would probably say $78,604. This is based on the couple looking at their 2006 tax return and their doing some very basic calculations as follows:

Federal Income Tax

Wages	$ 90,000
Standard Deduction	(10,300)
Personal Exemption.	(6,600)
Taxable Income	73,100
Tax	($11,396)

Cash Flow

Salary	$ 90,000
Federal income tax	(11,396)
Net cash flow	$ 78,604

This calculation is based on the most simple fact pattern, a couple living in a state that does not have an income tax. It also assumes the couple does not itemize their deductions, but instead takes the standard deduction. Most couples would look at the calculation and assume that in order to replace the $78,604 of net after-tax cash flow, they would need pension and/or IRA gross income of $90,000. They would be right. The net income tax would remain the same if the $90,000 of salary is replaced with $90,000 of taxable pension and/or IRA income.

financial planning program and calculate the actual effect.

[4] The analysis becomes much more complicated if the pre-retirement income includes interest and/or dividend income or if the retirement income consists of non-taxable income from a family trust or from a Roth IRA. Accordingly, those examples have not been discussed.

Effect of FICA Taxes

The fact that the net income tax is the same fails to take into account is that in addition to the income tax, salary is also subject to FICA taxes, also known as Social Security and Medicare taxes. In 2006, the first $94,200 of wages is subject to Social Security taxes of 6.2%,[5] and all salary is subject to Medicare taxes of 1.45%.[6] The real net income is therefore overstated above by the amount of the FICA taxes that is withheld from the worker's salary. In this case, with $90,000 of salary, the amount of FICA taxes is $6,885.

FICA Taxes

Social Security	($5,580)	($90.000 * 6.20 %)
Medicare	($1,305)	($90,000 * 1.45 %)
Total	($6,885)	($90,000 * 7.65 %)

The calculation of net cash flow above is therefore overstated by $6,885. The actual net cash flow on $90,000 of salary is therefore only $71,719 calculated as follows:

Cash Flow

Salary	$ 90,000
Federal income tax	(11,396)
Social Security tax	(5,580)
Medicare tax	(1,305)
Cash Flow	$ 71,719

Replacement of 100%: No More FICA Taxes. Salary and net earnings from self-employment are subject to Social Security and Medicare taxes. All other income is not subject to those taxes. If the couple can generate the same $90,000 of income from a pension, their after-tax cash flow would actually increase by $6,885, not coincidentally, the same amount as the FICA tax they no longer have to pay. The calculation follows.

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[5] Section 3101(a).

[6] Section 3101(b)(6). In addition, but not relevant here, is the fact that the employer must also pay these amounts to Social Security and Medicare, thus resulting in a combined tax rate of 15.3% on the maximum wage base for Social Security and a rate of 2.9% on all additional salary. See Section 3111.

Federal Income Tax

	Salary	Pension	Change
Wages	90,000	0	(90,000)
Pension	0	90,000	90,000
Standard Deduction	(10,300)	(10,300)	-
Personal Exemption	(6,600)	(6,600)	-
Taxable Income	73,100	73,100	-
Tax	(11,396)	(11,396)	-

Cash Flow

	Salary	Pension	Change
Net Income	90,000	90,000	-
Tax	(11,396)	(11,396)	-
Social Security	(5,580)		5,580
Medicare	(1,305)		1,305
Cash Flow	71,719	78,604	6,885

The 90% Solution: Pension Instead of Salary

As the above example illustrates, the couple does not need $90,000 of retirement income to generate the same after-tax net cash flow as they had before they retired. If their pension income is only $81,000, 90% of the former $90,000 salary, they will have $135 more after-tax cash flow. That's not a lot, but it is an increase with $9,000 less income.

Federal Income Tax

	Salary	Pension	Change
Wages	90,000		(90,000)
Pension		81,000	81,000
Standard Deduction	(10,300)	(10,300)	-
Personal Exemption	(6,600)	(6,600)	-
Taxable Income	73,100	64,100	(9,000)
Tax	(11,396)	(9,146)	2,250

Cash Flow

	Salary	Pension	Change
Net Income	90,000	81,000	(9,000)
Tax	(11,396)	(9,146)	2,250
Social Security	(5,580)		5,580
Medicare	(1,305)		1,305
Cash Flow	71,719	71,854	135

Mixture of Pension and Social Security

If part of the retirement income is made up of Social Security income, the couple can achieve the same after-tax cash flow with even less then 90% of their pre-retirement income because Social Security benefits are never fully taxable.[7] Instead of having a pension of $81,000, what if the taxpayers retire at and receive $80,000 of income, made up of $30,000 in Social Security benefits and $50,000 of pension and IRA benefits?[8] In that case, even though their gross cash flow has gone from $90,000 to $80,000, their net cash flow has actually increased by $490. A $1,000 reduction from the 90% income level actually increased cash flow by $355 ($490 - $135).

The chart shows that the taxable Social Security is only $23,850 because only a portion (never more then 85%) of Social Security benefits is taxable. The cash flow however reflects the entire $30,000 of the benefits received.[9]

Federal Income Tax

	Salary	Social Security	Change
Wages	90,000		(90,000)
Pension		50,000	50,000
Social Security		23,850	23,850
Standard Deduction	(10,300)	(10,300)	0
Personal Exemption	(6,600)	(6,600)	0
Taxable Income	73,100	56,950	(16,150)
Tax	(11,396)	(7,791)	3,605

Cash Flow

Net Income	90,000	80,000	(10,000)
Tax	(11,396)	(7,791)	3,605
Social Security	(5,580)		5,580
Medicare	(1,305)		1,305
Cash Flow	71,719	72,209	490

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[7] Social Security benefits are generally not even taxable unless modified adjusted gross income exceeds $25,000 if single and $32,000 if married filing a joint return. At that level, only 50% of the benefits are taxable. At higher income levels, up to 85% of the benefits become taxable.

[8] To make a fair comparison, the standard deduction has not been increased by the additional allowance for being 65 years of age or older. If the taxpayer itemizes instead of taking the standard deduction, age is not even a factor in calculating ones taxable income.

[9] The cash flow does not take into account the Medicare Part B premiums of $88.50 per month per recipient that are withheld from the Social Security benefits. That amount increases every year and may be means adjusted in the future.

State Taxation

Part of the tax savings during retirement is the fact that the taxpayers have to pay federal income tax on their entire salary even though they never received the $6,885 of income which was withheld as FICA taxes. That same phantom income is subject to state income taxes. Accordingly, retirement on 100% of after-tax net cash flow can be achieved with even less income if the salary is subject to state income taxes. Using the 90% example, since the taxpayer earns $9,000 less, their state tax will decrease by $450 if they are in the 5% marginal state tax bracket. If they live in California where their marginal tax rate is 9.3%, they would save over $800.

State taxes can also be reduced by moving out of a high tax state and relocating into a low or no tax state. In the "old days" this didn't work, at least in some states that continued to tax their former residents on their pension income because the income was earned in the former resident state. Since 1996, federal law prohibits the non resident state from taxing the pension income of its former residents.[10] Moving from Colorado to Nevada would save $3,385 on income of $90,000. Moving from New York City to Florida would save $6,887. States that do not have an income tax are Texas, Nevada, Alaska, Florida, South Dakota, Washington, and Wyoming. New Hampshire and Tennessee only tax dividends and interest.

Moving to a low tax state will reduce a taxpayer's income tax. Unfortunately that is not the entire tax picture. Each state has a variety of other taxes that may be higher or lower then those paid in the original state. Those taxes include property taxes, sales taxes, gasoline taxes, car, and cigarette taxes.

Taxpayers who sell their home to move to another state may also incur federal and state income taxes if their taxable gain is more then the "principal residence" exclusion of $250,000 if single and $500,000 if married.[11] If they buy a new home, the property taxes may increase substantially, even if the new home costs less, if the former state protected them from escalating property taxes.[12]

State income tax also varies when it comes to taxing Social Security benefits and pensions. Many states treat Social Security benefits as non taxable. A few states also exempt pension income from their tax base.[13]

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[10] See H.R. 394, State Taxation of Pension Income Act of 1995, PL 104-95 adding 4 U.S.C. 114 which prohibits states from taxing their former resident's pension income. On August 3, 2006, President Bush signed into law, H.R. 4019 (PL 109-264, to amend title 4 of the United States Code to clarify the treatment of self-employment for purposes of the limitation on state taxation of retirement income), which clarifies (retroactively) that states may not tax nonqualified retirement benefits paid by a partnership to its retired nonresident partners.

[11] Section 121(b)(1) and (2).

[12] See Robert C. Christopherson, "NOTE: Missing the Forest for the Trees: The Illusory Half-Policy of Senior Citizen Property Tax Relief," 13 Elder L.J. 195 (2005).

[13] For a chart of the state taxation of Social Security benefits and the taxation of pensions earned in another state, see www.rpea.org/pensiontaxes.htm (last visited 8/17/2006).

Roth IRAs

The benefit of a Roth IRA for those who qualify[14] is that unlike distributions from most pensions, when distributions are made from a Roth IRA, the cash received is not taxable. This result is preferable to a taxable distribution, but the cost of achieving this result was the loss of a tax deduction at the time of the contribution. Those who have Roth IRAs should carefully plan before taking Roth distributions. Once the proceeds are distributed, future earnings become taxable. If left in the Roth, they can grow tax free. Roth balances that are inherited continue to benefit from the tax free growth and tax free income. Thus, they make an excellent inheritance.

Qualifying Dividends and Long Term Capital Gain Income

Somewhere in between Roth IRAs being non taxable and regular pension distributions being taxable up to the maximum marginal tax rate of 35% is the treatment of qualifying dividend income and long term capital gains. Unlike most income, qualifying dividends and net long term capital gains are taxed at a maximum tax rate of 15%.[15] Of course, stocks usually have a lower current yield (dividend rate) then do certificates of deposit or U.S. Treasury obligations.

An investment of $100,000 in stocks may yield just $2,000 of current dividend income. The federal tax would be only $300 (15%). The same $100,000 could earn 5% on a certificate of deposit or a one or two year Treasury obligation. That $5,000 could be taxed at up to 35%, depending on the taxpayer's marginal tax rate. Thus, the tax could be as high as $1,750 (35% of $5,000). The net cash flow from the lower taxed dividends will therefore often be lower then the net cash flow from the higher taxed interest income, illustrated as follows:

Cash Flow

	Stocks	**CD**
Gross	$2,000	$5,000
Tax	(300)	(1,750)
Net Cash Flow	$1,700	$3,250

Current cash flow is not always the most important factor, especially if someone is trying to protect against the effects of inflations or they have a long life expectancy (because they retire early). Therefore, some financial advisors may recommend the lower current return from dividend income as a way of investing for growth.

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[14] Among other requirements, taxpayers only qualify for a full Roth contribution if their adjusted gross income is less then $150,000 if married and $95,000 if single. Section 408A(c)(ii).

[15] Section 1(h)(3).

Not Only Income Tax. The above examples assume that retirees will need 100% of their pre-retirement income. The calculations assume that the most important adjustment is federal income tax and FICA taxes. There are however many other expenses that either increase or decrease with retirement and age. These expenses very from worker to worker and from retiree to retiree. They are also affected by where one lives. All of these differences make any generic calculation of net cash flow next to impossible. Thus, these items are best handled by financial planners and accountants. It seems helpful however, to try to list some of these items.

Reduced Employee Expenses. Many expenses that are part of being an employee will be reduced or eliminated when retired. A list of items is helpful in planning. Examples of some of these costs that may disappear with retirement are:

1. State income taxes which can be eliminated by moving to another state.
2. State disability insurance paid by the employee. In California for example, employees pay SDI of $635, ($79,418 * 0.8%).
3. Union dues.
4. Parking and other commuting expense – gas and wear and tear on the car or bus passes.
5. Clothing and laundry expenses.
6. Continuing education expense and professional dues and subscriptions.
7. "Voluntary contributions" to charity or political causes that are encouraged by the employer or by fellow employees.
8. Involuntary contributions to the employer's pension fund
9. Voluntary contributions to a 401(k), 403(b), 457 pension plan or to a regular IRA or Roth IRA. This can amount to up to $20,000 per year or more.
10. Holiday, shower, wedding, retirement, and other co worker gifts

Reduced General Expenses. Some expenses not related to being an employee may also be reduced with retirement:

1. Medical insurance for those who turn 65 and therefore qualify for Medicare.
2. Car insurance may be reduced if the number of miles driven is substantially reduced during retirement.
3. Senior discounts for theaters, restaurants, theme parks, hotels, airlines and many other businesses.

4. Last minute savings on travel that can now be taken anytime rather then just during scheduled work vacations.
5. "Self help" savings – such as house cleaning, car wash, gardening, etc. that used to be provided by "independent contractors."

Increase in General Expenses. Unfortunately not all costs decrease during retirement. Many costs increase.

1. Health care cost – rehabilitation, convalescent hospital, nursing home, home assistance and hospice care.
2. Vacation travel often increases, especially in the early years of retirement.
3. Household energy costs may increase as the hours of home usage increases.
4. Hobbies may involve substantial outlays, including the cost of equipment or membership fees for golf, tennis, health clubs, social clubs, etc.
5. Gambling or online buying of goods may increase with additional free time.
6. Concerts, plays, movies, and other entertainment may increase.
7. One time large items such as a second (vacation) home, a 50^{th} anniversary party or the cost of a child's wedding are prevalent.
8. Insurance may increase, especially life insurance but also automobile and health insurance.
9. Charitable giving may increase.

Conclusion

Financial planning articles suggest that up to 100% of pre-retirement "income" is needed for the retirement years. These articles often discuss how income and expenses are affected by retirement. This article has illustrated that if a couple's retirement income is between 80% and 90% of their final pre-retirement income, their after-tax income may actually exceed their pre-retirement income. This knowledge may allow some workers to retire several years earlier then they had anticipated or it may let them spend more then they anticipated, knowing that they will actually have more after-tax cash flow when they retire then they anticipated.