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Early Retirement Considerations

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What is it?

As you near retirement age, you may be offered early retirement by your employer who may refer to the offer as a golden handshake or a golden parachute. The offer usually consists of severance payments and post-retirement medical coverage combined with already existing retirement benefits. While many early retirement offers appear attractive, it is important for you to review an offer carefully to ensure that it is indeed offering a golden opportunity.

Early retirement, IRAs, and retirement plans

If you accept an early retirement offer, make sure that you're aware of all possible implications. If you're going to be using the money from your IRA or retirement plan to fund your retirement, remember that in addition to income taxes, there may be penalties if you withdraw the funds prematurely. Or, there may be a limit on what you can withdraw without penalties.

Traditional defined benefit pension plans may be adversely impacted by retiring early. One reason is that the accrual of benefits under such a plan is generally the greatest during the final few years before retirement, which in most cases are the highest earning years. As a result, early retirement can result in considerably lower monthly retirement benefits from such a plan. On the other hand, employers sometimes sweeten early retirement packages, increasing your pension benefit beyond what you've earned by adding years to your age, length of service, or both, or by subsidizing your early retirement benefit or your qualified joint and survivor annuity option. These types of pension sweeteners are key features to look for in your employer's offer--especially if a reduced pension won't give you enough income.

Also, taxable distributions from employer-sponsored retirement plans are generally subject to the 10 percent premature distribution tax if made before age 59½. However, there are a number of exceptions to this rule. One important exception is for distributions made from 401(k)s and other qualified plans as a result of separation from service in the year you reach age 55 or later (age 50 for qualified public safety employees participating in governmental defined benefit plans). Another important exception from the 10 percent premature distribution tax is for substantially equal periodic payments (sometimes called SEPPs). Substantially equal periodic payments are amounts you receive from your IRA or qualified retirement plan not less frequently than annually for your life (or life expectancy) or the joint lives (or joint life expectancy) of you and your beneficiary. There is no minimum age requirement for this exception, but distributions from qualified retirement plans are eligible for the exception only after you separate from service.

Finally, if you're retiring early and plan on using your IRAs or retirement plans as a source of income, you should understand that you run the risk of depleting--or at least considerably reducing--such accounts. The reason is obvious: You have more years of retirement to fund than if you had waited to retire. Depending on how early you actually retire, you may find that you're going through those retirement accounts more quickly than you had originally intended. This could pose a problem both for your later retirement years when you need income the most, and for your plans to leave your beneficiaries with an inheritance. However, the possibility of depleting your retirement accounts may not be a major concern if you have no beneficiaries or if you have other income sources (such as job earnings or other investment assets) that will carry you through a lengthy retirement. But, you should at least be aware of the risk.

Severance payments

Severance payments are usually based on your salary and the number of years you have worked for the company. Severance payments can be distributed in either a lump sum or over the course of a number of years. A severance payment can provide you with a stream of income during your transition from one job to another. However, if you take another job soon after receiving the severance payment, it can put you into a higher tax bracket for the year.

> **Example(s):** Ben has 30 years of service with the local utility company, and grosses $675 per week before taxes. When Ben reaches age 57, his employer offers him an early retirement package. The

package includes a severance payment based on two weeks' salary for each year that Ben has worked for the company ($1,350 x 30 = $40,500).

Post-retirement medical coverage

Because of the high cost of medical care, you might find it hard to turn down an early retirement package that includes post-retirement medical coverage. These packages usually provide medical coverage until you reach age 65 and become eligible to receive Medicare.

Such post-retirement medical coverage is an important component to look for in an early retirement package. Without it, you will be forced to look into alternative sources of health insurance, such as the Consolidated Omnibus Budget Reconciliation Act (COBRA) or private health insurance to carry you through to the Medicare eligibility age. Unfortunately, COBRA provides only temporary benefits (up to a maximum of 18 or, in some cases, 36 months). And private health insurance premiums can be quite expensive, depending on such factors as your age and present health status. So, think carefully before accepting a package that doesn't include post-retirement medical coverage, especially if you have several years or more until you reach Medicare eligibility age.

However, don't make the mistake of assuming that all your health insurance needs will be met when you turn 65 and become covered under Medicare. The coverage provided by Medicare has gaps and often needs to be supplemented with a private individual policy and/or your own funds ("self-insure"). An early retirement package that provides medical coverage (full or reduced) well past the age of 65 (as some do) can be much more attractive than a package with coverage that ends at 65. You can sometimes negotiate for this extended medical coverage in an effort to sweeten the pot for yourself. Employers who feel strongly about having their offer accepted may very well agree to these terms.

Bridging

Another type of early retirement offer is the Social Security "bridge payment." Here, the employer provides you with temporary benefits to bridge the gap between early retirement and the beginning of your scheduled Social Security benefits. The temporary benefits are usually equivalent to the amount you will receive from Social Security at age 62.

> **Example(s):** Ben, age 57, works for a local utility company. The company offers Ben an early retirement package that includes five years of temporary benefits. These temporary benefits are equivalent to the amount that Ben will receive from Social Security at age 62. The benefits serve as a "bridge" between the period of Ben's early retirement at age 57 and the period when he becomes eligible for early Social Security benefits at age 62.

Social Security benefits

In general

If you accept an early retirement offer, you should also consider applying for early Social Security retirement benefits. The Social Security Administration gives anyone who is eligible to receive Social Security benefits at the normal retirement age the option to receive his or her benefits beginning at age 62.

> **Tip:** If you accept an early retirement offer from your employer, you are not required to receive early Social Security retirement benefits.

Basic calculation of benefits

Your Social Security benefits are based on what is known as the primary insurance amount (PIA). The PIA is based on your average indexed monthly earnings (AIME). If you retire at the normal retirement age (see the following Social Security Administration chart), your monthly benefit will be equal to your PIA. However, if you receive your Social Security retirement benefits early, your monthly benefit will be less than your PIA.

See our separate topic discussion Electing Early Social Security Retirement Benefits for details.

Social Security Administration Chart--normal retirement age

Age for Receiving Full Social Security Benefits

1943-1954	66
1955	66 and 2 months
1956	66 and 4 months
1957	66 and 6 months
1958	66 and 8 months
1959	66 and 10 months
1960 and later	67

Benefits reduced based on number of months before normal retirement age

If you retire early, you will receive more benefit checks than if you retire at normal retirement age. For instance, if your normal retirement age is 65 and you retire at age 62, you will receive 36 more benefit checks than you will if you wait until normal retirement age to retire. While this might seem profitable, you will suffer a permanent reduction in your monthly benefits. The reduced benefit is based on a deduction of approximately 5/9 of 1 percent (.0056) for each month you receive benefits prior to the normal retirement age, up to 36 months, and by 5/12 of 1 percent thereafter.

> **Example(s):** John retires at age 62 and elects to receive his Social Security benefits early. If John had waited to receive his Social Security benefits until his normal retirement age of 65, he would have received 100 percent of his PIA benefit or $800. Because John elected to receive his benefits at age 62, there is a reduction of 5/9 of 1 percent (.0056) for each of the 36 months that he receives benefits prior to his normal retirement age of 65. Thus, John will receive approximately $640, which is 20 percent less (.0056 x 36) than he would have received at age 65.

Other matters

- The application process for early Social Security retirement benefits can take as long as three months. The Social Security Administration recommends that you contact its office before your 62nd birthday.
- Even though you can receive early Social Security retirement benefits, you are not eligible for Medicare benefits until age 65.

For a more in-depth discussion on receiving Social Security benefits early, see our separate topic discussion, Electing Early Social Security Retirement Benefits.

Can you afford early retirement?

Whether you have the financial resources to retire early depends upon how much you expect to have in retirement income, and how much you plan to spend after you retire. Your early retirement income will include your early retirement package (severance payments and retirement benefits), Social Security (if you receive benefits before the normal retirement age), IRAs and employer-sponsored retirement plans, other savings and investments, and wages (if you work after early retirement). To determine how much you will spend, you must estimate your annual living expenses for early retirement. It is important to note that your annual living expenses during early retirement may differ from your expenses later in retirement. During early retirement, for example, you may find yourself still paying a mortgage, funding your children's education, or paying for medical coverage--if so, you may be free of these expenses during your later retirement years.

> **Tip:** If you find it difficult to estimate your annual early retirement living expenses, the Bureau of Labor and Statistics publishes a table of annual expenditures according to age.

What if you can't afford to retire? Finding a new job

You may find yourself having to accept an early retirement offer, even though you can't afford to retire. One way to make up for the difference between what you receive from your early retirement package and your old paycheck is to find a new job, but that doesn't mean that you have to abandon your former line of work for a new career. You can start by finding out if your former employer would hire you as a consultant. Or, you may find that you would like to turn what was once just a hobby into a second career. Then there is always the possibility of finding full-time or part-time employment with a new company.

If you have been out of the job market for a long time, you might not feel comfortable or have experience marketing yourself for a new job. Some companies provide career counseling to assist employees in re-entering the workforce. If your company does not provide you with this service, you may want to look into outplacement firms and nonprofit organizations in your area that deal with career transition.

> **Caution:** Many early retirement offers contain noncompetition agreements or offer monetary inducements on the condition that you agree not to work for a competitor. However, you should be able to work for a new employer and still receive your pension and other retirement plan benefits.

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