NORTHERN TRUST
ASSET MANAGEMENT

BOOST RETIREMENT WITH TAX WINDFALLS

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The Tax Cuts and Jobs Act (TCJA) of 2017 reduced individual and corporate income tax rates. Many companies are expecting to have lower tax obligations going forward. Among various ways to utilize the tax windfall, some companies chose to offer special bonuses, wage hikes, or bump-ups in employee retirement plans.

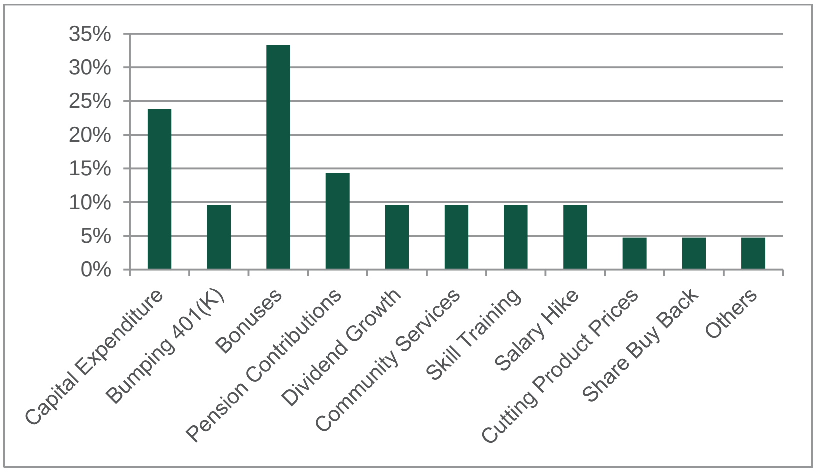
Suppose workers save the $1,000 bonus, which is a common amount handed out by large companies, into their retirement plan. How much wealth could they accumulate upon retirement? Let's explore the details.

CORPORATE ACTIONS WITH THE TAX WINDFALL

After the tax reform, a one-time cash bonus was the most popular way for employers to share the tax windfall with their employees (Figure 1); many employers took the opportunity to raise their capital expenditure; and some added contributions to workers' 401(k) or pension plans.

The chart summarizes actions among sponsors of the largest 50 defined contribution plans that are serviced by Northern Trust. Data search and collection was done for these companies one by one, but information was not publicly available for approximately half of them.

FIGURE 1: REPORTED COMPANY ACTIONS AFTER THE 2017 TAX REFORM



Source: Northern Trust Retirement Solutions data collection.

SMALL STEPS, BIG IMPACTS

If a 25-year old saved the $1,000 bonus, instead of spending it, she would have $7,040 upon retirement at age 65 (Figure 2). This shows the power of compounding on investment return over time. For simplicity, a constant 5% nominal return is assumed here. Actual returns will vary.

If the worker ratcheted up $1,000 in savings in all the subsequent years, she would accumulate $127,840 upon retirement. Getting started is often hard, but workers may thereafter appreciate the benefit of persistent savings. This tax windfall may be a push and help to form good habits.

Further, employers commonly provide matching contributions to their employee plans. Among large defined contribution plans serviced by Northern Trust, all employers are doing so, often with a 100% match rate, within certain limits.[1] Assuming a moderate match rate of 50% here, the serial savings of $1,000 into the worker's retirement account could generate $191,760 upon retirement.

The impacts of saving $1,000 would vary for older workers with different time horizons.

[1] Northern Trust Asset Management; *Top 50 DC Plan Highlights*; December 2017

FIGURE 2: POTENTIAL ADDITIONAL WEALTH UPON RETIREMENT

Current age of worker	25	35	45
No Employer Match			
Save $1,000, one time	7,040	$4,322	$2,653
Save $1,000, all subsequent years	127,840	$70,761	$35,719
50% employer match			
Save $1,000, one time	$10,560	$6,483	$3,980
Save $1,000, all subsequent years	$191,760	$106,141	$53,579

SOURCE: Northern Trust Retirement Solutions assumptions and calculations. For illustrative purposes only.

$7,040

THE POWER OF 5% COMPOUNDING INVESTMENT RETURN OF $1,000 OVER 40 YEARS

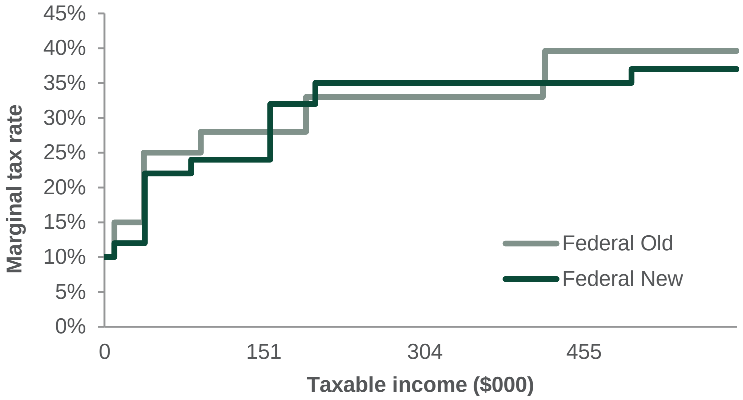
NEARLY UNIVERSAL IMPACT

As least 870,000 workers were eligible for a $1,000 bonus, according to USA Today, which only collected information for a small list of 14 companies (by no means exhaustive) for a short time window after the passage of the tax bill.[2] Americans for Tax Reform reported that more than 500 companies, big and small, had announced plans for pay raises, bonuses, utility rate cuts, or 401(k) hikes and at least four million Americans (still counting) will receive bonuses.[3]

Special bonus aside, the majority of workers may expect a federal tax reduction under the TCJA. Figure 3 shows the shift of marginal tax rates for single workers at various taxable income levels. For workers earning $50,000-100,000, for instance, they are estimated to have a lower federal tax bill by $1,300-2,700, after the application of the new standard deductions and tax brackets. Standard economic theory suggests that the workers should consume more now, because of the wealth effect, and also save part of the tax windfall so as to boost consumption in retirement.

[2] USA Today, "List of companies that paid bonuses or boosted pay since tax bill passed," Jan. 25, 2018.
[3] Americans for Tax Reform, List of Tax Reform Good News, https://www.atr.org/list, as of April 9, 2018.

FIGURE 3: COMPARISON OF OLD AND NEW TAX CODE



Source: Northern Trust Retirement Solutions, based on the Tax Cut and Jobs Act of 2017 and previous tax code.

Combining employee savings and special employer bonus, the workers could enjoy a more rapid accumulation of account assets. This is important because defined contribution plan participants tend to attach greater commitment to retirement preparation in association with a greater account value, as we documented earlier.[4] We highlighted that employer nudges, including default savings rate, auto-escalation, matching contributions, and bonuses, serve to accelerate the pace for workers to cross a $10,000 hurdle, beyond which workers are more likely to save persistently and stay invested for the long term.

Employer nudges serve to accelerate the pace for workers to cross a $10,000 hurdle.

CONCLUSION

Many workers received special cash bonuses after the tax reform. They could have saved them into their retirement plans. This is feasible because these bonuses were unexpected and were not part of their original budget for spending. In fact, most workers may realize that their budget constraint is relaxed (that is, more resources at disposal) under the new law.

[4] Sabrina Bailey and Gaobo Pang, 2016, "The $10,000 Hurdle," Northern Trust Asset Management

In the same spirit, employers could have offered special contributions to employee retirement plans, or do so next time in similar circumstances. As an act of libertarian paternalism, this would put the money out of employees' immediate reach. Employers' special boost and ongoing matching contributions could go a long way to strengthen workers' savings habit and ultimately nudge workers towards a better prepared retirement.

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[5] Asset under management as of March 31, 2018.

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