Benefit Planning, Inc.
Certified Financial Planner
1900 NW South Outer Road, Suite 200
Blue Springs MO 64015
816-229-5948

wguemmer@moneyconcepts.com

MONEY TALK

In a previous edition, I highlighted the withdrawal options from the TSP at retirement and touched on the positive merits of the TSP. In this article and the next, I'm going to share some compelling reasons to transfer most, if not all, of your TSP balance at the earliest possible time to an IRA. As you will see, the most obvious motivators are for easy access to your funds, estate planning, and tax reduction strategy purposes.

For many the most significant reason for **moving money out of TSP** is **due to the many limitations** placed on you to access your money inside your TSP account as outlined in my last article. The one noteworthy restriction is that you only get one lifetime partial withdrawal. The flexibility to access these funds is, in most cases, paramount for meeting financial needs. Think about that for a moment and then reflect on all the times you've written a check, gone through the drive thru at the bank or accessed funds via an ATM. The point I'm trying to illustrate is that for most Federal retirees, the TSP funds represent a large portion of their overall liquid net worth. As such, those funds are a vital component in meeting their financial needs. Conversely, after a TSP balance is transferred to an Individual Retirement Account (IRA), the account owner can request funds virtually any time and in any amount needed. After 27 years of helping Federal Employees with their retirement planning, I can assure you this is of the utmost importance for almost everyone.

Another **positive benefit of transferring funds from a TSP** account is the **opportunity to invest** in an almost **unlimited** lineup of **possibilities**. The TSP is limited to five primary funds and a blend of those five comprising the different Lifecycle Funds. These are index funds that are not receiving the potential benefits of an actively managed portfolio. The array of investment options outside of the TSP include real estate, annuities, mutual funds, exchange traded funds, precious metals or sector funds such as healthcare. Many Federal employees are unaware that they may take advantage of these outside investments after age 59 ½ by taking the one-time partial withdrawal using form TSP-75 while still in service. You will still be contributing to your TSP until retirement with the option of a final lump sum distribution that can be taken directly or transferred after retirement.

If a retiree has both a **Traditional TSP *and* a Roth TSP account**, any withdrawals are taken pro rata or proportionately from each. This doesn't allow you to choose which account you take the distribution from. In essence, you lose the ability to control the tax treatment of your withdrawal. This can also create unwanted consequences if you haven't had the Roth TSP account open and initially funded for at least five years before your first distribution is taken (and after you're 59 1/2 or older). If these qualifications aren't met, you will incur tax and penalties on the portion coming from the Roth side. It should be noted that normally a Roth IRA doesn't require minimum distributions (RMD'S) to begin at age 70 1/2 (unlike a traditional IRA). Funds left in the TSP Roth are subject to RMD'S. This can be a huge blow to your retirement plan, and it could be easily avoided by transferring away from the TSP.

Another potential lost opportunity of not transferring your TSP balance to your own IRA is the inability to do a **Roth conversion**, particularly in a bear market. Initiating a Roth conversion can be done anytime. However, converting all or a portion of your IRA when your account value dips due to a decline in the stock market means you will pay less in taxes at that time for the conversion. This is simply because the account value has been reduced for the moment. The conversion of a traditional IRA to a Roth IRA takes pre-tax dollars to an after-tax Roth account. My recommendation is to pay the taxes for the conversion from an outside source when due rather than taken from the account. Once this is complete, this will allow for tax-free withdrawals from your growing Roth account. This will also allow you the opportunity to leave a legacy of **tax-free income to potential heirs** that they will receive during their lifetimes. This can also be done systematically through the years to lessen the taxes due upon conversion. Again, I want to reiterate, within a TSP, because of the one-time partial withdrawal stipulation, you won't be able to provide this benefit.

The final point I want to touch on could be incredibly important to your estate plan. It won't impact you, but it could be devastating to the estate you leave to your heirs. Let's look at some TSP rules for inheriting a TSP account:

Once the TSP has been notified of the **death of a TSP account holder**, they will verify beneficiaries and (usually within 30 days) send out a decision letter to all eligible beneficiaries. If the deceased TSP account holder was married, the account automatically becomes a beneficiary participant account. Only the surviving spouse has the option to leave the funds with the TSP or transfer the account to their own IRA. They basically will have the funds treated as their own for tax and withdrawal purposes. In this scenario, everything is so far, so good.

The problem with this scenario is that, once the **surviving spouse dies** and the beneficiaries are in position to receive the remaining balance, only one choice for distribution is available. In my opinion, that one choice is not a good one. Since funds from a beneficiary participant account cannot be transferred to an inherited IRA, the beneficiaries will have to take a direct payment from the TSP. This eliminates the chance to establish an inherited IRA for the beneficiaries and offer them the chance to take lifetime income from the account, thus spacing out the payment of taxes due. Rather, taxes owed will be due as a result of the distribution. This means that if the account is large, a significant portion of the inheritance will be lost to taxes.

Here's a real-world **illustration of the above scenario**: If a beneficiary participant account had a value of $500,000 upon death of the owner, a sole beneficiary would receive this as a fully taxable distribution. This means that the money is taxed as ordinary income to the beneficiary, graduating them into the highest tax bracket for one year, even if they had no ordinary income of their own outside of the inheritance. Currently the highest federal bracket is 39.6%. The state taxes must be paid on top of that. It isn't difficult to see that the beneficiary could easily lose a large portion of the original balance. If the account had been transferred to an IRA the remaining balance could have maintained its tax deferred status. That should get your attention.

Allow me to offer you another possibility. Let's say that the original **TSP account holder dies leaving the account to someone other than a spouse**. The TSP would allow for each beneficiary of the account to transfer their portion to an inherited IRA. The inherited IRA would allow the owner to take income from the account balance over their individual lifetime. This has the potential to greatly reduce the tax burden by spreading it out over many years, while the account is still potentially growing at fair return. It should be noted that in this situation, the beneficiaries must have the funds they're entitled to directly transferred to the new custodian of the inherited IRA. If the funds are not directly transferred, the beneficiaries won't be permitted to roll the money over to the inherited IRA even if they attempt to do so during the customary 60 day window.

If the **surviving spouse has their own TSP account**, then the deceased spouse's account could be rolled into theirs without losing the ability for the next beneficiary to have an Inherited IRA. Additionally, if the surviving spouse is under the age of 59 1/2 , it might make sense to leave some or all of the account with the TSP until they reach 59 1/2. The IRS will treat the account as a death benefit and won't subject it to any distribution penalties prior to age 59 ½ (there is normally a 10% penalty associated with early distributions from IRA's). It does, however, put the funds at risk if the surviving spouse should die before transferring funds from the TSP to an IRA.

If you have read my previous 2 editions regarding the TSP, you should have a better understanding of the pros and cons of the whole picture. Most notably on the positive side are the low fees of the TSP. In my opinion there are pitfalls to be avoided and you can control and readily access your funds better once you have TSP funds transferred to an IRA as early as age 59 ½ with the one time distribution opportunity. If it makes sense for you to look into transferring your TSP to an IRA, I'd like to offer to help you with that and other financial matters. I take my fiduciary duty very seriously, have a fair and transparent fee structure, and would be happy to help you review all viable options in order to make the best choices for you and your family's financial future.