Traditional vs. Roth Thrift Savings Plan

A closer look at the two options available for TSP contributions

By CDR Shad Thomas '98 and Robert Shaye '04

The Thrift Savings Plan (TSP), the Federal Government and military's version of the 401(k), is a fantastic, low-fee way for Coast Guard members to save for retirement. The plan has recently added a new option for making contributions, yet the benefits of this feature are not widely understood. The Roth option was introduced to the TSP in 2012 and represented a significant alternative to making contributions to your TSP account. While Traditional (pre-tax) contributions are beneficial for some members, Roth (after-tax) contributions offer a substantial advantage for active duty members who are generally in a low tax bracket. Though the Roth option has been available for three years, many members remain unaware of the advantages of the Roth and continue to make Traditional contributions to their TSP accounts. Choosing between Traditional and Roth can have a substantial impact on the value of your retirement savings, and our goal is to make sure you have the information needed to make the best decision for your circumstances.

Traditional vs. Roth — The Basics

Traditional contributions are pre-tax contributions where the contribution is taken out of your paycheck before income is taxed. The money that is contributed to your TSP will grow tax deferred, and you will pay taxes on your contribution and their earnings upon withdrawal in retirement[1]. For example, if you make Traditional contributions of $5,000 into your TSP account in 2015 and that money grows to say $25,000 upon retirement, you will pay taxes on the $5,000 contribution plus the $20,000 in earnings when you withdraw them. If you are in the 28% marginal tax bracket in retirement and you withdraw that $25,000, you will pay 28% ($7,000) in taxes.

The Traditional option appeals to members that wish to lower their current taxable income. Using the previous example, a member making a $5,000 Traditional contribution to their TSP account will lower their taxable income by $5,000 for 2015. As a general rule, if you think your tax rate will be less during retirement years than it is today, you should make Traditional contributions.

Roth contributions are after-tax contributions where the contribution is taxed during the current tax year. The money that is contributed to your TSP will grow tax-free and you will not pay taxes on contributions or earnings upon retirement[2]. For example, if you make a Roth contribution of $5,000 that grows to $25,000 upon retirement, you will not have to pay taxes on either the $5,000 contribution or the $20,000 in earnings when you withdraw them during retirement, since taxes were paid on the initial contribution of $5,000.

Traditional vs. Roth — How to Decide

Now that we've covered the difference between Roth and Traditional contributions, let's talk about how to decide between the two. It is important to remember that "Uncle Sam will always[3] get paid," meaning you are going to pay taxes one way or another on your contributions. The difference is when you are going to pay them. As eluded to before, the crux of the debate is your current tax bracket and how that will compare to your tax bracket in

1. *www.tsp.gov*

2. *Ibid.*

3. *The only time Uncle Sam doesn't get paid is when military members are serving in a combat zone. In this scenario, their income is tax-free and it can go right into a Roth, thereby avoiding all taxes. TSP contribution limits are also raised for those serving in a combat zone.*

retirement. We examined three different scenarios to illustrate this point:

1. Your tax bracket now is the same as it is in retirement. If this were true, you would be completely indifferent to Traditional and Roth contributions and you would get the same amount of money in retirement. However, most people are not in the same tax bracket in retirement as they were during their working years.
2. Your tax bracket now is less than it will be in retirement. If this were true, you would prefer Roth contributions because you are paying your tax now and you would get more money in retirement than if you had made Traditional contributions.
3. Your tax bracket now is more than it will be in retirement. If this were true, you would prefer Traditional contributions because you are paying your tax later and you would get more money in retirement than if you had made Roth contributions.

The Case for Roth

"Okay, I got it. It all depends on my tax bracket now versus my tax bracket in retirement. But how will I know that?" Well, most military members are "tax-lucky," meaning we have the advantage of great tax breaks. Specifically, our BAH and BAS (and overseas COLA for OCONUS members) are not included in our taxable income. Depending on your BAH rate, this could mean you are only taxed on about 65% of your real income. For example, let's say you are an O-3 with over 8 years of service stationed in Boston, MA. Monthly Base Pay is $5,744, BAH (without dependents) is $2,892 and BAS is $253. This means your annual income is $106,700, but in the eyes of the IRS you only earn $69,000. Effectively, you are only being taxed on 65% of your actual income, which puts you in a lower tax bracket than if you held a comparable job in the civilian sector that paid $106,700. Because we are in such a low tax bracket now, it often makes sense to pay the taxes now (make Roth contributions). This is especially true if you are planning on transitioning to the civilian world soon. Make Roth contributions now, because they will be more "costly" when you don't get those tax breaks. Roth contributions are even "cheaper" if you happen to have a state tax-free domicile, which many military members do because of frequent PCS transfers.

Here's another example that further illustrates the low tax-rates for active duty members. An E-5 in Alameda, CA with over 8 years of service earns a monthly Base Pay of $2,951. BAH (we'll use with dependents this time) is $3,132 per month and BAS is $368. This totals to an annual salary of $77,400, but only $35,400 is taxable to the IRS. That's only 46% of his or her actual compensation!

"But what about if I stay in the Coast Guard for over 20 years and get a military pension?" First, only approximately 17% of military members stay in the service long enough to get a pension, so please keep that in mind and don't necessarily count on getting that monthly check. But let's see what it looks like if that same LT in Boston made CDR and stayed for 20 years and received a retirement. An O-5 with 20 years of service would receive a monthly pension of around $4,000/month. That money is all taxable and will be added to whatever other income they receive (Social Security, taxable investments, bonds, or maybe a second pension). While your Social Security benefit depends on how much you've paid into the system, an estimate for that LT in Boston when he or she is 62 and eligible to receive it is around $1,000/month. You can quickly see that it is very likely your monthly earnings in retirement will be greater than your current earnings, making Roth contributions favorable.

The Case for Traditional

While Roth contributions are better for most military members, let's look at a few examples where Traditional contributions may be better:

1. You are married to a high-earning spouse and you file taxes jointly. Your spouse's salary may be bumping you both into a high tax bracket now and perhaps you would benefit more from the tax-break of Traditional contributions.

2. You are senior in the military and have few deductions, Traditional contributions lower your current year tax liability.
3. You plan to retire from the military at 20 years to a low cost of living area that does not tax military pensions and live solely off your pension, minimal TSP withdrawals, and social security. In this scenario, your tax rate could be lower in retirement.
4. You believe tax rates are going to decrease in the future or the tax law will change. (Tax brackets are at a historic low for most Americans. We certainly don't hear chatter about the government having extra money laying around and reducing taxes in the future!)

The Roth Advantage

Another reason Roth contributions are attractive is due to a pesky little thing called RMDs. It stands for Required Minimum Distributions and they apply when you turn 70½. While that may seem like eternity, talk to any elderly person who is financially well-off and they will tell you how annoying RMDs are. In short, the government requires you to withdraw money from your accounts and add to your taxable income, even if you don't need or want the money. RMDs apply to Traditional 401(k)s/TSPs, Traditional IRAs, and Roth 401(k)s/TSPs. Roth IRAs do not have RMDs. How does that help? Well, when you leave government service and if you are concerned about forcibly taking income, you could roll your Roth TSP into a Roth IRA and therefore exclude it from RMDs.

Roth accounts are also beneficial because of their superior wealth transfer benefits for passing money down to future generations. There are many nuances with Inherited IRAs, including if the beneficiary is a spouse or non-spouse, and how long the money has been in the account. Without going into all the details, leaving your heirs a Roth account is far better because there are no taxes on the distributions they must take from the account. Distributions from Traditional accounts, in contrast, are taxed at your heirs' current tax bracket. This can be very costly if, for example, your daughter is a high earner and already in a high tax-bracket. She would have to pay taxes on the distributions at her current tax-bracket, which leaves less money to her in the end. Had you left her a Roth account, all those distributions would be tax-free.

Mechanics of TSP Transactions

Switching your contributions from Traditional to Roth takes less than 5 minutes and can be completed online via Direct Access (myPay for DoD members). Also use Direct Access to start/stop contributions, and change the contribution percent of your pay.

Selecting or changing your portfolio allocation (% of balance in G, F, C, S, I, and L Funds) is accomplished through the TSP website (www.tsp.gov) and requires your account number and password. Two online transactions are commonly used: Contribution Allocation directs future contributions to your selection of funds, and Interfund Transfers directs the balance already in your account to your selection of funds.

It is important to note that when you switch contributions from Traditional to Roth, you will have two separate balances, or "buckets" of money in your TSP account: The Traditional bucket, which still has a tax liability, and the Roth bucket, which does not. The Traditional portion will continue to grow based on your fund allocation even though you're no longer making Traditional contributions. Under current TSP rules, you cannot convert your existing Traditional TSP balance to your Roth TSP. If the rules change and this is allowed in the future, you will have to pay taxes on the Traditional balance of the conversion at your tax rate during the year of the transfer.

Hedge Option

If you are unsure about switching to Roth, consider hedging your tax exposure by contributing some to Traditional and some to Roth. For example, you could make $9,000 of each type of contribution, thereby getting somewhat of a tax-break now, but also saving some money tax-free. Alternatively, you could hedge by holding a Roth IRA and Traditional TSP. This method also gives you more options in retirement on which accounts to draw your money from. By having some money in a Traditional account, some in a Roth, and some in a taxable account, you can choose which account to draw from each year depending on your financial situation and tax bracket at that time.

Additional Retirement Account Information

Aside from the Roth vs. Traditional analysis, here are some other very important considerations for your retirement accounts:

1. The TSP contribution limit increased again in 2015 to $18,000 (with an additional $6,000 ($24,000 total) if you are age 50 or older). This is completely separate from the $5,500 IRA limit (or $6,500 if you are age 50 or older). If you can afford it, you can squirrel away $23,500 in retirement savings per year. To be clear on Roth contributions, if you are under the age of 50, in 2015 you can contribute $18,000 to your Roth TSP and $5,500 to your Roth IRA. This is a tremendous tax advantage for many active duty members!
2. Don't let your money sit in the G Fund, which is the default fund. While safe, it barely keeps up with inflation. If you have a 15-20 year horizon until you need the money, consider a Lifecycle Fund that aligns with your projected retirement date.
3. If you are about to leave the military and don't yet have a TSP, start one immediately and contribute at least $200. Let's say you work for 10 years at a civilian employer and amass $100,000 in your 401(k). When you leave that employer, you can roll the $100,000 into the TSP to take advantage of their low fees.
4. Overall the TSP is a fantastic way for us to save, but it does fall short in some areas. Most notably, there are only five fund choices, with no exposure to Emerging Markets, TIPS (Treasury Inflation Protected Securities), or REITs (Real Estate Investment Trusts). Well-diversified portfolios have lower volatility, so consider getting some exposure to these in your non-TSP accounts, such as your IRA, by using low-cost, indexed, exchange traded funds (ETFs).
5. TSP and IRA investments offer us substantial tax advantages over the long run. However, retirement accounts are illiquid assets and there is a significant penalty for withdrawing funds prior to age 59½. Therefore, the TSP and IRA should not be relied on for short-term expenses (i.e. making a down payment on a house or paying off credit card debt).
6. When you eventually leave the military, do not immediately roll your TSP into an IRA. Many financial advisors will try to convince you to do so, because they stand to gain financially if you do. Sadly, many military members do this every year, only to be exposed to fees that are often 10-20 times higher than the TSP. (The TSP has the lowest fees in the industry, averaging 2.9 basis points, or 29 cents for every $1,000 invested[4]).

Managing your TSP

The shift from defined benefit plans (pensions) to defined contribution plans (401(k)s) has clearly taken place in the private sector. Since attention has now shifted toward military pensions, managing your Thrift Savings Plan properly is more important than ever. Perhaps one of the most critical decisions to make with your TSP is the decision between Roth and Traditional contributions. Switching from Traditional contributions to Roth contributions requires us to change our strategy for retirement savings, which can be difficult to do. A high percentage of active duty members that we've trained have a Roth IRA and a Traditional TSP, because Traditional was the only option they had when they established their TSP account. They've built a successful strategy with their retirement accounts and are on track for a healthy retirement. However, we'd argue that they should consider making Roth contributions to their TSP account to optimize for the future and greatly enhance their retirement strategy.

4. Ibid

CDR Thomas is a 1998 graduate of CGA and holds an MBA from Vanderbilt University Owen Graduate School of Management. He has commanded the cutters POINT BRIDGE, HALIBUT, TYBEE, and KISKA. He currently serves as the Comptroller and Base Operations Department Head at Base Honolulu, and is President of American Society of Military Comptrollers (ASMC) Aloha Chapter.

Robert Shaye is a 2004 graduate of CGA and holds an MBA from the UC Berkeley Haas School of Business. He was Active Duty for 10 years and served aboard cutter TAHOMA and Barque EAGLE. He is now the Director of Customer Education at FutureAdvisor in San Francisco, where he teaches others how to invest smartly and save for retirement.